S. HRG. 101-131

REAUTHORIZATIONS FOR THE SECURITIES AND EXCHANGE COMMISSION, 1990–92

HEARING

BEFORE THE

SUBCOMMITTEE ON SECURITIES

OF THE

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS UNITED STATES SENATE

ONE HUNDRED FIRST CONGRESS

FIRST SESSION

ON

TO AMEND THE SECURITIES EXCHANGE ACT OF 1934 TO AUTHORIZE APPROPRIATIONS FOR THE SECURITIES AND EXCHANGE COMMISSION FOR FISCAL YEARS 1990–92

(S. 646, INTERNATIONAL SECURITIES ENFORCEMENT COOPERATION ACT OF 1989; S. 647, SECURITIES LAW ENFORCEMENT REMEDIES ACT OF 1989; S. 648, MARKET REFORM ACT OF 1989; S. 649, SHAREHOLDER COMMUNICATIONS IMPROVEMENT ACT OF 1989; AND S. 651, TRUST INDENTURE REFORM ACT OF 1989)

APRIL 18, 1989

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REAUTHORIZATIONS FOR THE SECURITIES AND EXCHANGE COMMISSION, 1990–92

TUESDAY, APRIL 18, 1989

U.S. SENATE,
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS,
SUBCOMMITTEE ON SECURITIES,
Washington, DC.

The subcommittee met at 10:38 a.m., in room SD–538 of the Dirksen Senate Office Building, Senator Christopher J. Dodd (chairman of the subcommittee) presiding.

Present: Senators Dodd, Riegle, Heinz, D'Amato, and Pressler.

OPENING STATEMENT OF SENATOR DODD

Senator DODD. The Subcommittee on Securities, the Committee on Banking, Housing and Urban Affairs will come to order.

This morning we are considering the budget authorization for the Securities and Exchange Commission for fiscal years 1990 through 1992.

Let me welcome everyone here this morning for the first hearing of the Subcommittee on Securities in this Congress.

We also thank you, Chairman Ruder, for appearing here today.

As everyone knows, the FSLIC bill is on the floor at this very moment, and a number of our colleagues in this committee, having spent countless hours on that issue, are now on the Senate floor dealing with those issues. They would have liked to have been here this morning.

I am pleased to see my colleagues, Senators D'Amato and Pressler, who have arrived, and my ranking minority member, Senator Heinz of Pennsylvania, particularly. We did not want to delay this hearing, Mr. Chairman. It is important that we move ahead with the SEC's budget authorization and begin considering a number of other issues that are extremely important to our capital markets and, indeed, to our economy as a whole.

In addition to funding issues, today's hearing will focus on five bills submitted to Congress by the SEC, which Senator Heinz and I have introduced at the request of the agency—the International Securities Enforcement Cooperation Act, the Securities Law Enforcement Remedies Act, the Market Reform Act, the Shareholder the Communications Improvement Act, and the Trust Indenture Reform Act.

Some of these bills will be the subject of later hearings. In June we will turn to hearings on the internationalization of securities markets.

In addition, Senator Heinz and I have agreed that the issues raised by leveraged buyouts should be explored in broader hearings on corporate governance. We hope to turn to those specific concerns later this year.

We will also hold hearings on SEC enforcement and the legislation proposed by the SEC for increased authority in this area.

I believe it is entirely appropriate that we deal with the questions about the SEC's funding while the Senate as a whole is grappling with the FSLIC crisis. I hope we can apply the lessons from that experience to the issue before us today. When we fail to provide the funds needed to staff a regulatory agency and fail to pay for the highest quality professionals we can find, and when we replace tough and sound regulation with lax rules for an industry that holds the savings of millions of Americans, then we leave too many opportunities for unscrupulous or simply incompetent individuals to engage in activities that undermine the honest and talented members of that industry.

The result is that the taxpayers foot the bill and pay many times more than whatever regulatory costs were saved. Our economy as a whole obviously suffers. I believe we cannot afford "not" to increase funds for this small agency—and it is a small agency—whose effectiveness is vital to the capital raising process in this country.

The numbers alone make a compelling argument. Since 1980, annual trading on the stock exchanges has grown more than 300 percent. Over-the-counter volume has increased by more than 465 percent.

The number of broker/dealers has increased 88 percent. The number of registered representatives has increased 145 percent.

In this same period, the number of investment companies has grown by 146 percent, and assets of those companies have increased 411 percent. The number of investment advisers has more than tripled since 1980, and the assets under management have increased 945 percent, now totaling $4.4 trillion. That is greater than the combined deposits of banks and savings and loan institutions.

The number of registration statements filed annually with the SEC has doubled since 1980. The number of tender offer schedules has increased 669 percent and complaints of the SEC have grown by more than 250 percent.

During this same period, global trading activities have grown exponentially. Foreign trading in U.S. stocks grew more than 550 percent since 1980, and U.S. trading in foreign stocks has increased 950 percent. We have seen the development of new instruments, such as the stocks index futures, and new trading strategies such as program trading.

In short, not only have the areas under the SEC's jurisdiction grown dramatically, they have expanded beyond our borders and have become far more complex as well.

However, during this period, SEC staff levels remained virtually static. The total SEC staff-years in 1980 were 2,041. Today's staff-years total 2,050. Despite the dedication and hard work of its staff, the SEC's ability to enforce the laws under its jurisdiction has been affected quite clearly.

Although the SEC recently brought the largest securities fraud case in history, it also declined to bring charges in the largest municipal bond default in history.

The SEC inspects investment advisers only once every 12 years. It reviews only 19 percent of all annual reports filed by public companies, and in light of these facts, both the securities industry and the corporate community—and this is rare, indeed, but it is true—are urging us to increase SEC funding.

The president of the Securities Industry Association, Ed O'Brian, in an April 7 letter to me wrote:

> No one in our industry benefits if the SEC is underfunded and ill-equipped to detect, pursue, and prosecute those who betray the public's trust. Though we as an industry may disagree with the Commission from time to time, we support the work of the SEC and strongly believe that this agency must have additional resources if it is to carry out its statutory responsibilities in today's market.

The president of the National Association of Manufacturers, Sandy Trowbridge, in an April 12 letter to me wrote:

> There is currently widespread concern that the Commission has not received sufficient funds to even maintain past staffing levels. Given the increased complexities of our financial markets, growing concern by small investors, and reported fraudulent activities and, consequently, the increased demands placed upon the Commission, the NAM believes it is essential that the presently proposed funding levels be increased.

I might observe that the NAM is not normally in the business of calling for increases in spending.

Mr. Trowbridge added:

> Our Nation's recent experience with the thrift industry has shown that dollars saved by limited Federal oversight pale in comparison to the dollars lost through mismanagement and fraud. It is also instructive that while the industries regulated by the SEC want a fully funded regulator, they also want a tough regulator.

I agree with Mr. Trowbridge's remarks.

Chairman Ruder, under your chairmanship the Commission has proposed market reform legislation which would impose tough requirements on the securities industry. It has proposed new civil penalties which could be imposed on corporate officials. It has brought the largest securities fraud case against a broker/dealer in our Nation's history, and you have advocated in some cases positions which have put you at odds with the very administration that hired you.

Yet when industry officials and corporate officials have come to see me, I must tell you candidly, they applaud you and your staff. They may disagree with you on certain issues, but they support you as a tough and effective regulator.

I want to tell you that this subcommittee and the Congress as a whole owe you our thanks for a job well done, and we look forward to working with you in this Congress to move forward.

It is refreshing to have a Government official propose new ideas. Not all of them, I presume, my subcommittee, my ranking minority member, and I are going to agree with. There may be things we will disagree with, but the fact that you are coming forward with ideas and creative suggestions and ways to make this system work better is exactly what you ought to be doing. Frankly, I would rather have you propose ideas that I disagree with than not pro-

pose any at all, and it is refreshing to have someone come up with some new good ideas, and clearly this is an area that demands it.

But the numbers alone indicate the problems we face in terms of making this agency work effectively. I now would like to turn to my ranking minority member. We have denied him a microphone.

OPENING REMARKS OF SENATOR HEINZ

Senator HEINZ. That is what happens when you sit next to Senator D'Amato, Mr. Chairman. [Laughter.]

Mr. Chairman, first, let me add my commendations and my invitation to David Ruder to continue to come to us with his ideas. They are valuable. Let me also commend you, Mr. Chairman, for having the foresight of holding this hearing today. I should also acknowledge the fortitude of this committee and its members, who have been involved in the S&L markup and hearings for many months. In addition Senator Dodd just completed an absolutely outstanding, articulate presentation on the ABC child care bill. Not everybody agreed with him, but it was one of the best presentations I have ever heard any member make before a committee. Senator Dodd made his presentation in record time and he was here on time.

Senator DODD. We have to vote in 5 minutes.

Senator HEINZ. I just want to make a couple of brief comments about these hearings.

First, no matter how much time the thrift crisis has consumed, life does go on. The markets remain open. Capital must be raised, and fraud in those markets must be detected and deterred.

So we are here today to discuss the resources that must be devoted to ensuring that markets do remain in operation, that capital is raised efficiently, and that our markets continue to be the fairest and, most importantly, the most honest in the world.

With respect to the need for resources, Senator Dodd has made, on behalf of the SEC, a truly outstanding case. It probably needs no emphasis that the SEC needs resources to effectively carry out its regulatory mandate. As we look to the future, I too am increasingly concerned about whether the SEC will continue to have adequate resources to do the job properly.

The markets, as Chairman Dodd has outlined, have grown dramatically. They have become ever more complex and sophisticated. That makes oversight ever more difficult.

One of the issues I am concerned with, Mr. Chairman, is maintaining the fairness and integrity of our capital markets. That means, in particular, vigilant and vigorous enforcement of the Federal securities laws.

I heartily applaud the Commission's demonstrated ability to ride herd on Wall Street. The round-up of inside traders over the past several years has been impressive.

But I have this gnawing concern that while we focus our attention on Wall Street, other pastures have been left relatively untended, with those horse thieves and cattle rustlers roaming free. One of those verdant pastures is the penny stock market. The recent Hughes capital case shows that we are beginning to come to grips with the enormity of the task.

The sodbusters of the marketplace, the small investors are systematically being bilked out of millions, if not billions, of dollars of hard earned savings by the con artists and card sharks of the securities markets employing a variety of blind pools, boiler room shops, and other market manipulations.

We need a very tough Federal marshal, one who cannot only catch these crooks, but make sure they are thrown into jail and put out of business permanently.

Another of these pastures—Senator Dodd alluded to it—is the global securities market, and my concern is that we don't have a fence up yet. In fact, fraud artists may be increasingly moving their operations offshore to take advantage of the laws of some countries that are willing to be havens for this kind of insidious activity.

Back to the issue of the SEC budget.

I know that most people were shocked, even stunned to note in the Drexel/Milken investigation, that Drexel Lambert paid Michael Milken $550 million in 1 year.

Now, I think we all applaud entrepreneurship, but that compares to a $135 million for the entire SEC for 1 year. In other words, one person that the SEC is responsible for regulating made four times the agency's budget. It is a truly remarkable irony.

Mr. Ruder, I think we all look forward to your testimony. I see we have a vote on the floor.

The issues that you have raised constitute a very full plate, not only for this but for subsequent hearings, and I join Chairman Dodd in thanking you for being here.

[Senator Heinz' complete prepared statement follows:]

PREPARED STATEMENT OF SENATOR HEINZ

As we begin the first in an ambitious series of hearings for the Securities Subcommittee in the 101st Congress, I would like to commend you, Mr. Chairman, on your foresight and fortitude in holding this important hearing today. As everyone knows, the members of the Senate Banking Committee and their staffs have been kept extraordinarily busy in efforts to resolve the savings and loan crisis in a rapid and responsible manner. I believe the bill we reported out of the full committee last Wednesday shows convincingly that we're moving in that direction.

No matter how time consuming the thrift crisis, however, we can ill afford to shirk our other responsibilities. Life does go on—markets remain open—capital must be raised—and fraud in those markets must be detected and deterred. So we are here today to discuss the resources that will be devoted to ensuring that markets do remain in operation, that capital is raised efficiently, and that our markets continue to be the fairest and most honest in the world.

I think it is most appropriate, therefore, that we have as the lead witness in our inaugural Securities Subcommittee hearing, the Chairman of the Securities and Exchange Commission. Mr. Ruder, I would like to extend my personal thanks and appreciation to you—both for being with us here this morning and, more importantly, for the extraordinarily fine job you have done under exceedingly difficult circumstances. Since you first took the helm of the SEC a little over 1½ years ago, the Commission has been confronted with one crisis after another. First and foremost, of course, was the October 1987 market crash. There have also been the resource intensive investigations—successful ones I might add—of Dennis Levine, Ivan Boesky, Michael Milken, and Drexel, Burnham, Lambert. And during this time, and under your able helmsmanship, the Commission has stayed its regulatory course—ensuring efficient capital formation and protecting investors. There have been ample opportunities for you to relinquish the helm and allow the Commission to run aground, creating a financial disaster of epic proportions. Thankfully, that has not happened.

Today we are here to talk about resources—the legislative and financial resources the SEC needs to effectively carry out its regulatory mandate. Despite the fine job the SEC has done to date, Mr. Chairman, as we look to the future I am increasingly concerned about whether the SEC will continue to have adequate resources to do its job properly. The markets have grown dramatically and become ever more complex and sophisticated, making oversight ever more difficult.

One of the issues I am most concerned with, Mr. Chairman, is maintaining the fairness and integrity of our capital markets. That means vigilant and vigorous enforcement of the Federal securities laws. I heartily applaud the Commission's demonstrated ability to ride herd on Wall Street. The roundup of insider traders over the past several years has been impressive. The announcement of the Drexel settlement last Thursday is an important capstone in the ongoing investigation of Levine, Boesky, Milken, et al. I'm sure we'll hear additional discussion of the settlement as the morning progresses

I have this gnawing concern, however, that while we've focused our attention on Wall Street, other pastures have been left relatively untended, with the horse thieves and cattle rustlers roaming free. One of those verdant pastures is the penny stock market. I recognize that the Commission has recently established a penny stock fraud task force, and Attorney General Dick Thornburgh has also devoted additional resources to this pressing problem. I just hope the horses aren't already out of the stable. The recent Hughes capital case, among others, shows that we are just beginning to come to grips with the enormity of this issue. The small investors—the sodbusters of the marketplace—are systematically being bilked out of millions, if not billions, of dollars of hard-earned savings by the con artists and card sharks of the securities markets, employing a variety of Ponzi schemes, blind-pools, boiler room shops and other market manipulations. We need a tough Federal marshal—one who can not only catch these crooks, but make sure they are thrown in jail, and put out of business permanently

Another of these pastures is the global securities market. My concern is that we don't even have a fence up yet. As the markets have become increasingly internationalized, so too have the opportunities for fraud increased. The recent securities scandals in France and Japan, and the Thomas Quinn affair demonstrate that securities fraud occurs everywhere. In fact, fraud artists may be increasingly moving their operations offshore to take advantage of the laws of some countries that are willing to be havens for this kind of insidious activity. Many countries also have blocking and secrecy laws which make the detection and deterrence of fraud more difficult. We cannot, however, allow securities law violators the unfettered ability to practice fraud upon American investors from afar without fear of prosecution. It is incumbent upon us to make sure that we have the necessary resources to combat international securities fraud. I would categorically state that the SEC should not be put in a position where it declines to pursue an investigation in a foreign jurisdiction because to do so would be too costly.

Mr. Chairman, I think it is also appropriate to put the issue of the SEC's budget in a useful context. I was quite frankly shocked, as I'm sure others were, to learn recently that Drexel paid Mr. Milken $550 million in 1 year. I applaud entrepreneurship, and would be the first to contend that true enterpreneurs should be able to reap whatever rewards the market will provide from their legitimate activities. Nonetheless, I am given pause when I think that the entirety of the SEC's budget was $135 million last year and one person the SEC is responsible for regulating made four times that. It's a truly remarkable irony. When you also look at the enormous fees of investment banks, and lawyers in takeover transactions, its no wonder that the Federal Government has great difficulty in attracting and retaining talented staff. There are certainly greener pastures elsewhere.

Mr. Ruder, I look forward to your testimony not only on the issues I've discussed, but also with respect to the legislation that Senator Dodd and I recently introduced at the Commission's public-airing, and if the benefits of each of those bills are established on the record, as I'm sure they will be, then we should move forward as expediently as possible to see that they are enacted.

Senator DODD. Thank you very much, Senator Heinz, and I should say at the outset I couldn't have been happier to have Senator Heinz as my ranking minority member on this committee, as he has a deep interest and long experience. He understands the issues very well and will make a good partner, in this effort over the next number of months.

And Senator D'Amato, of course, is the person who represents a great many of the businesses we are talking about.

Senator D'Amato, do you have some opening remarks?

We will try to get our opening statements in here before the vote, and then we will come back, Chairman Ruder, and we will take your statement at the conclusion.

Senator D'AMATO. I am going to ask that my statement be included in the record as if read in its entirety.

Senator DODD. Without objection. I also have a statement from Senator Sanford to be inserted in the record.

[The statements of Senators D'Amato and Sanford follow:]

STATEMENT OF SENATOR D'AMATO

Mr. Chairman, I would like to commend you for scheduling these hearings. Despite the current state of seige in the Banking Committee, we do have other business to tend to besides the FSLIC deficit. Certainly keeping the Securities Exchange Commission up and running is a matter of sufficient importance to take some of our time even in a state of emergency. Therefore, I would like to welcome Chairman Ruder to the subcommittee and assure him of my continuing, intense interest in both the role and the efficient operation of the SEC.

Second, but certainly no less important on my mind is to acknowledge my friend, Senator Dodd as he assumes the chairmanship of the Securities Subcommittee, a subcommittee chairmanship which I most thoroughly enjoyed during my tenure some years ago. I am certain that under the leadership of Senator Dodd and my distinguished colleague, Senator Heinz, the ranking member, we can look forward to a stimulating and productive session in the Securities Subcommittee during this Congress.

STATEMENT OF SENATOR TERRY SANFORD

Thank you, Mr. Chairman, and I join you in welcoming Chairman Ruder to the subcommittee hearing this morning. I also want to thank Chairman Ruder for his frank depiction of the funding levels at the SEC and the problems the SEC is facing in meeting the tremendous demands that are being placed on it by ever changing technology, unprecedented levels of insider trading and other significant enforcement actions, tremendous volatility in the markets, and the development of new types of program trading, index options and other products which require ever more sophisticated monitoring.

Given that, I would like to emphasize the importance of seeking adequate funding for the SEC. Much of our efforts this Congress have been toward trying to implement proper reforms in the savings and loans industry. We have seen the problems within this industry escalate because adequate funding was not provided which would have allowed the necessary examination and supervision of the thrifts. I believe it is imperative that we learn from this lesson, and provide the SEC with funding levels necessary to enable them to examine and supervise the markets and its many participants, thus thwarting crisis developments.

Chairman Ruder, I was pleased to notice that the Commission will be undertaking a study of leveraged buyouts. The findings of the study will point out abuses within the leveraged buyout process, particularly as it relates to management conflicts of interest. It is my hope, Mr. Chairman, that once the FSLIC issue is settled, we can turn our attention to leveraged buyouts and corporate takeovers and begin to develop reform measures to correct the abuses.

Finally, I would like to express my appreciation to Chairman Ruder for his efforts in developing legislation to modernize the Trust Indenture Act of 1939. Significant changes have occurred in the bond market since 1939, and I believe it is time to amend the Act to reflect those changes to better protect the bond holders while providing needed new efficiences in the issuance and underwriting of bonds.

Thank you, Mr. Chairman.

Senator D'AMATO. Let me commend you for calling these hearings at this time, notwithstanding the legislation which is pending on the floor.

Let me also say how fortunate I think we are to have you leading this subcommittee along with Senator Heinz. I think it is important that we have someone who has your energy, your insight.

As you have outlined in your opening remarks, there is much to be done.

For a number of years I had the unfortunate position of having to advocate increased funding for the SEC in light of the administration's adamant objection to that, and I might say my good friend, who was the Chairman before you, Ambassador Shad, articulated that position. He was a good soldier, but we are behind the '8' ball, so to speak, in not having in the battlefield the kinds of resources, the skilled attorneys and accountants and others, who would make the job of protecting the marketplace, one which is so important that—one which could be accomplished with much more thoroughness.

And I think, notwithstanding that, you, Mr. Chairman, Chairman Ruder, your enforcement people under the great leadership of Gary Lynch, who absolutely has done a great job with the dedicated staff, ought to be commended for having been as vigilant and having been as successful as you have been with the limited resources, and it is good to see that we have a meeting of the minds here.

I would suggest that you just submit your statement as if read in its entirety and take the largess which the chairman has offered you.

Mr. Chairman, it is good to be here.

Senator DODD. Thank you very much, Senator D'Amato.

Senator Pressler.

OPENING STATEMENT OF SENATOR PRESSLER

Senator PRESSLER. Thank you very much, Mr. Chairman.

I join in the various remarks that have been made about our chairman and ranking member and also Chairman Ruder. Let me say that I have a unique interest this morning. My home State of South Dakota and other Midwestern States are facing the possibility of two transportation takeovers. California investor, Marvin Davis, has made an offer to acquire Northwest Airlines, and an investor group known as Japon, Inc. Partners is engaged in a fight for the Chicago & Northwestern Railroad.

In view of the very evident public interest in such takeovers—and I hope the Chairman will address this in his remarks—should not the SEC have different rules about takeovers that affect the broad public interests such as I refer to? Can this be accomplished under existing statutes?

It is my strongest feeling that our State is hostage insofar as transportation is concerned, and so are two or three others, and we are left in a very uncertain state, and this is not necessarily to be submitted to the Department of Transportation because the people trying to buy these transportation entities are not transportation companies.

Is the standard purpose of transactions statement, as found in schedule 13(D), adequate to protect the interests of the public? Should farmers who rely on the C&NW for hauling grain be al-

lowed to know what may happen to that railroad? Should business people who have no other option for air transportation than Northwest Airlines have the right to know what may happen to the service?

What I am saying, Mr. Chairman and fellow members of the committee, is that there is a real public interest out there that is being compromised by these giant takeovers, and I for one, speaking as one Senator, feel that the broad public interest is going to have to be concerned in some of these matters.

I have—we have Secretary Baker, I think, in Foreign Relations—in the Commerce Committee screaming at me to be there for a markup. So I will try to be here.

OPENING STATEMENT OF SENATOR RIEGLE

Senator RIEGLE. Thank you very much, Senator Pressler.

Those are the second bells on this vote. So I know that you and Senator D'Amato need to go and make that vote. I have just completed it.

I will at this time make my opening statement.

I will not be able to stay at length. We are handling the savings and loan FSLIC issue on the Senate floor, but I want to make clear that I look forward to working very closely with Senator Dodd, Senator Heinz, and the other members of the subcommittee in moving and passing meaningful securities legislation this Congress and hopefully this year.

As the former chairman of the subcommittee, I am aware that we have a great deal of unfinished work to attend to in the securities area, and I view that as one of the most important areas of work for the committee as we are in the early going of this new session of Congress.

So I am very much committed to working with Chairman Dodd and the subcommittee toward passing legislation as soon as possible—as we possibly can in the following areas—additional international securities enforcement cooperation; improvements to the Shareholder Communications Act; improved intermarket coordination; and increased SEC regulatory authority over the reporting of large trades.

These issues were noncontroversial at the end of the last Congress and were not adopted only because they became entangled in the debate over financial modernization and tender offer legislation.

I also support the consideration by the subcommittee of initiatives in the following areas—further market reform, increased civil penalties in the enforcement area, improvements in the Trust Indenture Act, and a review of the leveraged buyout process.

As a result of my own work on the subcommittee last year, I remain very interested in ensuring that the new special study of the securities markets authorized in the Insider Trading and Securities Fraud Enforcement Act of 1988 gets funded in this year's SEC authorization.

Also, Chairman Dodd knows, of course, of my ongoing interest and initiatives in the clarification of the laws on insider trading as

well as self-funding for the Commission, provided it is adequately coupled with adequate congressional oversight.

And I might say that, speaking with Chairman Dingell from the House just yesterday on that very issue, he and I had the occasion to fly out to Michigan with President Bush for an event that we participated in in Michigan yesterday.

And finally, one question has repeatedly been raised by the press and others regarding the Drexel Burnham settlement with the Commission, and that is whether our failure to supervise "laws" are adequate and whether they are being sufficiently and aggressively enforced by the Commission and the self-regulatory organizations.

Yesterday the Wall Street Journal had a front page story, "Fred Joseph Emerges Unscathed After Deal By Drexel and SEC. Some Reason That the Chief Should Have Faced Action For Failing to Supervise. Where Does the Buck Stop?"

And I think those kinds of questions and issues are still ones that require further attention by this subcommittee and of course then by the full committee.

So my primary purpose in coming over from the floor, where I am managing the FSLIC bill this morning, is to lend to Senator Dodd and the subcommittee as a whole my very, very strong support in their legislative efforts this year and to indicate that the full committee stands ready to mark up legislation as soon as the subcommittee has it ready for us.

So with that, let me excuse myself, Chairman Ruder. I have got to get back to the floor because we have got amendments to manage there at the present time.

So the committee will stand in recess momentarily until Senator Dodd returns.

[Recess.]

Senator DODD. The subcommittee will come to order.

Mr. Chairman, I apologize to you. I think we are going to get a long enough window here—I hope we are now—without some additional votes. So we will be able to receive your testimony.

Your testimony will be included in full in the record. I have read it, every word, so if you want to paraphrase, please do. You cover a lot of ground. I will let you proceed in any way in which you are comfortable.

But if you prefer to hit on some of the high points, some of my questions refer to various parts of the testimony, and that may be an easier way for you to proceed. This way we can cover ground a bit more quickly than have you go through a 30-page document—and single-spaced, I think. Is it single-spaced?

At 1 o'clock this morning it looked single-spaced. [Laughter.]

Mr. RUDER. Thank you. I look forward——

Senator DODD. I just saw Senator Fritz Hollings, our colleague on the elevator. I told him I was here with you, and he said, "You tell that Chairman we will get him any kind of money he wants."

Now, if you understand what I just said.

Mr. RUDER. I like those words.

Senator HEINZ. Would you say that in English?

Senator DODD. I will provide a translation later.

STATEMENT OF DAVID S. RUDER, CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION, WASHINGTON, DC

Mr. RUDER. We have submitted to you prior to this hearing our budget authorization request, which is a separate document and which covers a fairly large number of pages, as well as a written statement which I am pleased to know that you will include in the hearing record.

I had prepared an oral statement, but your opening statement covered some of the matters that I had included in it, and if I may, I will try to hit some of the high spots and perhaps emphasize a few of them and add a few matters that were not covered in your opening statement.

The Commission has since 1934 had a major role in protecting the integrity of the nation's security markets, and we believe that as our securities markets in the future become more internationalized and interdependent, as financial instruments become increasingly complex and as the securities industry undergoes a period of growth, including automation, we will need additional funds to meet our needs.

In the enforcement area, I think the recently settled case against Drexel Burnham Lambert indicates the vigor of our enforcement. We do agree that we do not have sufficient resources now to act as vigorously as we need to in many areas, and that is particularly true as we mobilize our efforts against penny stock fraud and market manipulation in general.

One of the outgrowths of our Drexel Burnham settlement will be a continuation of enforcement investigations in the highly complex professional areas, and additional resources are needed for those objectives.

The Commission's market regulation staff is also experiencing serious resource limitations.

As you indicated in your opening remarks, Chairman Dodd, the percentages of increases in regulated entities, in market volume, and in the number of registered representatives have been dramatic, while at the same time our market regulation staff has actually declined in number.

In my view, the market regulation division needs additional resources so that it can adequately regulate the broker-dealer firms and supervise the nation's securities markets, including the exchanges.

We believe at this time we also need additional resources to establish a vitally needed capital markets unit and to implement Commission initiatives arising out of the October 1987 market break.

One of the conclusions that I have reached regarding the role of the Commission in the future is that it will become much more of a financial regulator and much more concerned with the operation of the markets than it has in the past, and we need market regulation staff for that purpose.

In the full disclosure area we have been doing the best we can to review filed documents, but the numbers there, as you have indicated, have also increased dramatically. At the same time, we need support for the implementation of EDGAR, the Commission's elec-

tronic filing system for disclosure documents. That system will become operational in a few years, and during the interim period we need additional staff for the purpose of drafting rules to prepare for a fully implemented electronic filing system, and certainly, if the administration's proposal that the Commission regulate certain bank and thrift securities is adopted, the Commission will need additional resources to meet these new responsibilities in the full disclosure area.

The investment management program, which you referred to, illustrates, I think, the very dramatic growth in activity at the same time that we have not had an increase in staff.

Our Investment Management Division is, in my view and I think in the view of many, lean and mean in its approach to regulation. It does the best it can with limited resources, but a dramatic resource increase in that area is necessary if it is to be able to perform its inspection needs and its regulatory responsibilities.

A footnote to this is that in the Public Utility Holding Company Act area we are also in need of additional staff as that industry becomes increasingly complex, and the needs of those people that we regulate need to be addressed.

In addition to the four program areas, I must tell you that we have a need for experienced legal services. These services are provided by the Commission's Office of the General Counsel. This office represents the Commission in all appellate litigation and defends the Commission in suits challenging the agency's rulemaking and other orders and enforcement authority.

In a sense, the greater our enforcement efforts are and the greater our other activities are, the greater the burdens on our legal services staff. So we need a core area increase in staffing there.

There are other areas of the Commission, including administrative areas such as automation, customer complaints, public reference room, and other areas, which need corollary increases.

We have asked for authorization for approximately $178 million in our 1990 authorization, approximately $212 million in our 1991 authorization, and approximately $238 million in our 1992 authorization.

I believe that these numbers are realistic estimates of increases which we need to meet new programs and new demands on the Commission.

Thank you.

[The complete prepared statement of David S. Ruder follows:]

STATEMENT OF DAVID S. RUDER
CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION
BEFORE THE SENATE SUBCOMMITTEE ON SECURITIES OF THE
SENATE COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

CONCERNING THE COMMISSION'S AUTHORIZATION REQUEST
FOR FISCAL YEARS 1990-92

April 18, 1989

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STATEMENT OF DAVID S. RUDER
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CONCERNING THE COMMISSION'S AUTHORIZATION REQUEST
FOR FISCAL YEARS 1990-92

April 18, 1989

Chairman Dodd and Members of the Subcommittee:

The Securities and Exchange Commission appreciates this opportunity to present an overview of its ongoing efforts as well as to discuss the Commission's authorization request for 1990-92 and its need for additional resources. The Commission requests that the separate statement setting forth the Commission's 1990-92 authorization request, previously submitted to this Subcommittee, be included in the record.

I. INTRODUCTION AND EXECUTIVE SUMMARY

In recent years, the number and magnitude of the tasks faced by the Commission have grown dramatically, while its staff has grown very little. The Commission's operations are efficient, but its resources are strained. Additional resources are needed to ensure that the Commission can continue to exercise effectively its statutory responsibilities. This 1990-92 authorization request is intended to provide the Commission with the resources needed to regulate the nation's securities markets.

The Commission seeks a three-year statutory authorization for appropriations in the following amounts: $178.0 million for 1990, $212.6 million for 1991, and $238.1 million for 1992.

Since its creation in 1934, the Commission has played a major role in protecting the integrity of the nation's securities markets. Over the next several years, the Commission will face great challenges to its ability to protect these markets. These challenges include the need to maintain and expand the Commission's vigorous enforcement program, the problem of fraud in the penny stock market, continued growth of the securities industry, increasing complexity of financial instruments and techniques, increasing interdependence of the financial markets, and the requirements of intergovernmental and interagency coordination and cooperation resulting from the internationalization of the markets. The Commission also needs to continue the computerization of its operations. Implementing the Commission's programs in all of these areas requires long-range planning, extensive study, and carefully measured implementation. The three-year authorization sought by the Commission will strengthen the Commission's ability to plan and carry out its programs.

Commission activities are organized around four programs: Enforcement, Market Regulation, Full Disclosure, and Investment Management Regulation. Each of these programs requires additional resources over the next three fiscal years if it is to meet the Commission's important statutory responsibilities for the protection of investors and the maintenance of orderly markets.

The Commission's Enforcement program is responsible for investigating possible violations of the federal securities laws and initiating civil injunctive actions and administrative disciplinary proceedings when evidence of violations is found. The Commission's enforcement staff continues to exercise this mandate vigorously. Sales on United States securities exchanges totaled approximately $1.8 trillion in 1988, as compared with approximately $.7 trillion in 1982. Likewise, the volume of investor inquiries has increased significantly. In 1987, the Commission received 230% more complaints and inquiries from investors than it did in 1982. The National Association of Securities Dealers reported receiving approximately 340% more complaints in 1987 than in 1982. Moreover, in 1988, the Commission experienced an additional 22% increase in the number of investor complaints and inquiries, with a total number of 49,000 received that year. Commission resources, however, have not kept pace. In addition, the Commission now devotes a greater percentage of resources to complex litigation and matters involving foreign trading, which further strain the limited resources available for more routine but nevertheless important enforcement matters. Without additional resources, the Commission's enforcement staff will be unable to maintain its current pace of enforcement actions while at the same time devoting sufficient resources to its recent crackdown on penny stock fraud and manipulation.

The Division of Market Regulation is responsible for the regulation of broker-dealer firms and the supervision of the Nation's securities markets. From 1980 to 1988, there has been an estimated 88% increase in the number of registered broker-dealer firms and an estimated 145% increase in the number of registered representatives, while the Division's staff years during the same period actually declined. The Division needs additional resources over the next three years to enable it to perform its supervisory functions, to establish a vitally needed capital markets group, to pursue Commission initiatives arising out of the October 1987 market crash, and to address regulatory issues in the market for municipal securities. In addition, the Commission's broker-dealer examination staff will need additional resources to ensure that it can continue to detect abusive sales and trading practices.

The mission of the Commission's Full Disclosure program is to provide investors with material information and to prevent

fraud and misrepresentation in the public offering, trading, voting, and tendering of securities. The Commission's disclosure staff reviews disclosure filings from approximately 14,000 public companies. From 1980 to 1988, there was a 135% increase in the number of registration statements filed, and a 175% increase in the number of merger proxies filed. The transactions and securities under review have also become more novel and complex. This program will require additional resources over the next several years to permit it to provide adequate review of disclosure filings, to continue its review of leveraged buyouts and other takeover activities, and to respond to market developments. In addition, the Commission will require additional resources to continue its implementation of its electronic filing system for disclosure documents. If the Administration's proposal to subject publicly-issued bank and thrift securities to Commission regulation is adopted, the Division of Corporation Finance will need additional staff to administer those requirements of the federal securities laws applicable to banks and savings and loans.

The Investment Management Program seeks to minimize the risk of investor loss through the review of disclosure, regulation, and inspection of investment companies and investment advisers. This program also seeks to ensure that public utility holding companies operate in the public interest and have sound financial structures. From the end of fiscal year 1980 through fiscal year 1989, the number of registered investment companies increased by an estimated 146%, while the number of registered investment advisers increased an estimated 217%. However, the Commission's examination staff has not increased significantly since 1980. The Commission needs additional resources to devote to this program to provide adequate levels of inspection and regulation of investment companies and advisers, as well as to meet the significant challenges presented by industry growth, more diverse financial products, and greater internationalization of the financial markets.

In addition to requiring adequate resources for these four programs, the Commission also must have access to high quality legal services, provided by the Commission's Office of the General Counsel. This Office represents the Commission in all appellate litigation, including litigation where the Commission appears as amicus curiae. The Office is also responsible for defending the Commission in suits challenging the Commission's rulemaking and administrative orders and enforcement authority, and for prosecuting certain disciplinary proceedings against professionals who practice before the Commission. Additionally, the Office provides a variety of legal advisory services to the Commission, responds to Congressional inquiries, and assists Congress in the drafting of legislation. The increased level of Commission enforcement and legislative activity will continue to place additional burdens on the Office's staff. The Office will

need additional resources in the next three years in order to ensure that it can meet these challenges in the legal and legislative areas.

The Commission has been actively addressing concerns raised by the increasing internationalization of the securities markets. In March of this year, the Commission submitted a legislative proposal to Congress that would enhance international cooperation in the enforcement of the securities laws. The Commission also has proposed Regulation S, which is intended to clarify the extraterritorial application of the registration provisions of the Securities Act, and Rule 144A, which would provide a safe harbor from the Securities Act registration requirements for specified offers, sales, and resales of securities to institutional investors. The Commission's staff is also developing an initial multi-jurisdictional registration experiment with Canada. These and other Commission initiatives designed to address the internationalization of the world's securities markets will continue to require substantial staff resources.

In each of the last six fiscal years, due largely to increased market activity, registration, transfer, and other fees received by the Commission have significantly exceeded the Commission's budget. In its recent Self-Funding Study, the Commission's staff found that the agency needs special new authorities in order to attract and retain quality staff, and developed five specific recommendations to accomplish this goal.

II. THE COMMISSION'S ENFORCEMENT PROGRAM

A. Workload

The Commission has authority under the federal securities laws to investigate possible securities law violations and, when unlawful conduct is discovered, to bring enforcement actions in federal court, to institute administrative proceedings, or to refer matters to the United States Department of Justice for criminal prosecution. The Commission continues to exercise vigorously its authority to enforce the securities laws. Increases in workload without sufficient increases in Commission resources could, however, hamper the Commission's enforcement efforts. In fact, a limitation in Commission resources was one of several factors the Commission considered when it recently decided not to initiate its own enforcement action in the Washington Public Power Supply System matter.

In 1987, the Commission received over 40,000 complaints and inquiries from investors, over 230% the number received in 1982. The National Association of Securities Dealers reported receiving over 5,000 additional complaints, approximately 340% more than the number it received in 1982. In 1988, the Commission experienced an additional 22% increase in the number of investor

complaints and inquiries, with a total number of 49,000 received that year. Moreover, as discussed below, the Commission's enforcement investigations and litigation have become increasingly complex and thus necessitate a greater expenditure of staff resources.

B. The Effect of Complex Litigation

The Commission's enforcement program is comprehensive and includes cases involving fraudulent securities offerings, corporate reporting and accounting violations, violations by broker-dealers and other regulated entities, insider trading, and market manipulation.

In recent years, the nature of the Commission's investigations and litigation has become increasingly complex. Two recent cases that exemplify this increased complexity are SEC v. Drexel Burnham Lambert Incorporated, et al., No. 88 Civ. 6209 (S.D.N.Y. filed Sept. 7, 1988) and SEC v. Stephen Sui-Kuan Wang Jr., and Fred C. Lee, a/k/a Chwan Hong Lee, No. 88 Civ. 4461 (S.D.N.Y. filed June 27, 1988). Drexel Burnham is an injunctive action in which the Commission alleges that the investment banking firm, the head of its high yield and convertible bond department, and others devised and carried out a scheme involving fraud, insider trading, stock manipulation, nondisclosure of required information concerning the beneficial ownership of securities, and numerous other securities law violations. The action illustrates the increasingly detailed, complex, and litigious aspects of the Commission's determination to pursue fraudulent activities of securities professionals. The complaint alleges that at least sixteen series of illegal transactions resulted from a secret arrangement with Ivan Boesky, who was enjoined and barred from the securities business by the Commission in November 1986 and agreed to pay as settlement $100 million in disgorgement and penalties. The complaint further alleges that in at least two transactions not involving Boesky, Drexel and its official traded while in possession of material nonpublic information obtained through misappropriation or in breach of a fiduciary duty owed to Drexel's clients. With the Commission's assistance, the U.S. Attorney for the Southern District of New York has brought a related criminal action against Drexel. Drexel has tentatively agreed to pay $650 million in fines and disgorgement as part of the resolution of that matter. The Commission has devoted more than 35 staff years to this matter, while Drexel and the other defendants are reported to have expended tens of millions of dollars in the case.

SEC v. Wang and Lee reflects the complexities arising from the internationalization of the securities markets. In Wang, the Commission alleged that an analyst in the mergers and acquisitions department of a major investment banking firm illicitly provided information concerning proposed mergers and other

extraordinary transactions involving the firm's clients to a Taiwanese investor residing in Hong Kong. While in possession of this information, the investor allegedly directed the purchase and sale of securities of at least 25 issuers through various accounts, realizing at least $19 million in illegal profits. The Commission obtained a temporary restraining order from the federal district court in Manhattan, including a freeze of all assets belonging to the investor, the companies he controlled, and his trading nominees. The freeze order extended to a bank with branch offices in both New York and Hong Kong. Following entry of the order, the investor attempted unsuccessfully to retrieve funds from the Hong Kong branch of the bank. At the Commission's request, the court ordered the defendants not to seek further relief from the previous order in either foreign or United States courts, and to pay over $12 million from the bank's account into the registry of the court. This aspect of the case is still being litigated. The analyst, whose alleged benefit from the trading scheme was estimated at $200,000, pleaded guilty to criminal charges, and was sentenced to a three-year prison term, to be followed by three years of probation.

Complex cases such as Drexel Burnham and Wang require greater staff resources than do routine securities fraud cases. Moreover, because of the substantial sums of money at stake in these kinds of cases, defendants are more likely to engage in protracted litigation with the Commission. It is imperative that, in order to maintain justified investor confidence in the integrity of the U.S. securities markets, the Commission continue to bring such cases when it believes that unlawful conduct has occurred. The Commission also will continue to work with Congress, the other enforcement agencies, and foreign regulatory agencies, to facilitate increasingly complicated securities law investigations and enforcement actions.

As the number of complicated matters pursued by the Commission increases, it becomes increasingly difficult to find resources to pursue more routine but nevertheless important enforcement matters. Without additional resources, the Commission may be forced to forego some major enforcement actions in order to preserve a good balance in the Commission's enforcement program. For example, in 1983, the Washington Public Power Supply System ("Supply System") defaulted on $2.25 billion in principal of tax-exempt bonds sold to finance the construction of two nuclear power plants. The default on the bonds was the largest payment default in the history of the municipal bond market. The staff's investigation 1/ revealed serious concerns as to whether the official statements for the Supply System's

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1/ Securities and Exchange Commission Staff Report on the Investigation in the Matter of Transactions in Washington Public Power Supply System Securities (1988).

bonds adequately disclosed significant factors and as to the conduct of various professionals involved. However, the Commission determined not to pursue the matter, in part due to concern as to the level of resources necessary to litigate the case.

C. Prevention of Fraud in the Penny Stock Market

The Commission is mobilizing its efforts to protect small investors from penny stock fraud and manipulation. "Penny stocks" are low-priced, over-the-counter securities that sometimes are quoted in the National Association of Securities Dealers' Automated Quotation System ("NASDAQ"), 2/ but usually are quoted in a medium such as the National Quotation Bureau's "pink sheets." 3/ Because these stocks generally are thinly-traded and may be subject to domination and control by a single market maker, they can be an attractive vehicle for manipulation and fraud.

The Division of Market Regulation's broker-dealer examination program and the Division of Enforcement's investigations have revealed serious problems of fraud and manipulation in the market for penny stocks. In the summer of 1988, the Commission's broker-dealer examination program undertook a special sweep of examinations targeted at penny stock firms. Of the 17 initial examinations, 14 resulted in enforcement referrals. The Commission's broker-dealer examination program will continue to target penny stock firms over the next several years.

In response to the problem of penny stock fraud, the Commission organized a Task Force on Penny Stock Manipulation. The purpose of the Task Force is to identify the problems posed by penny stock manipulation, to consider regulatory solutions to those problems, and to consider how to educate investors regarding the dangers of penny stock fraud. The Task Force also

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2/ Volume and price information with respect to exchange listed or NASDAQ quoted stocks is collected electronically and continually published so that investors can determine recent volume and price movement. Price and volume information with respect to penny stocks normally is not collected automatically and made readily available to the public. Brokerage firms trading a penny stock can usually provide information only about trades they make.

3/ The "pink sheets" are a daily publication that reflects market maker interest in thousands of over-the-counter stocks, including penny stocks. The market makers may publish bid and ask quotations for specific securities or simply advertise their general interest in receiving bids or offers for specific securities.

seeks to improve coordination and information-sharing with other law enforcement agencies in order to strengthen the Commission's regulatory and enforcement programs. The Commission is holding regional meetings around the country with regulatory and law enforcement officials from state and federal agencies to facilitate more vigorous civil and criminal prosecution of penny stock frauds. The Commission is also preparing a training program on penny stock fraud for U.S. Attorneys, the Federal Bureau of Investigation, the U.S. Customs Service, the U.S. Postal Inspection Service, the Internal Revenue Service/Criminal Investigation Division, state authorities, and international law enforcement officials. The training program will be held this summer.

The Commission has accelerated its enforcement efforts against individuals involved in a wide array of misconduct in connection with the penny stock market. In 1988, the Commission initiated more than 25 enforcement actions involving fraud or abuse in the penny stock market, and suspended over-the-counter trading in more than 100 penny stocks.

In addition, the Commission has been increasingly involved in joint investigations of fraudulent penny stock schemes with other law enforcement agencies. Of particular interest is the recent thirty-six count indictment announced in Salt Lake City on January 18, 1989, relating to manipulation in the securities of Protecto Industries. This indictment involved the joint efforts of the U.S. Attorney for the State of Utah, the FBI, and the Commission's Salt Lake City and Denver offices. The Commission's Miami Branch Office has organized a Florida Penny Stock Task Force that includes representatives of the IRS, the FBI, state securities authorities, and the U.S. Attorney. Policing market manipulation in the penny stock market is critical to continued investor confidence.

Many fraudulent and manipulative schemes depend on the abusive sales tactics of certain broker-dealers, such as high pressure cold calls. To address these abuses, the Commission has proposed Exchange Act Rule 15c2-6, 4/ which would require broker-dealers, prior to the sale of certain pink sheet securities to persons who are not regular customers, to obtain a written customer agreement to the sale, and to make a written determination that the security is a suitable investment for the customer. The Commission is also formulating other regulatory initiatives to address manipulation schemes in the penny stock area.

4/ Securities Exchange Act Release No. 26529 (February 8, 1989), 54 Fed. Reg. 6693 (1989).

In addition, to promote investor education, the Task Force has written and distributed a flyer that sets forth basic information about penny stocks, discusses warning signs of penny stock fraud, and recommends certain measures to take before investing in penny stocks. There has been a significant amount of publicity directed to penny stock fraud in the last several months and the Commission is actively seeking to continue publicizing the risks to investors from fraudulent penny stock schemes.

D. Enforcement Efforts Involving Fraud Connected with Banks and Savings and Loans

In recent years, the Commission has brought a number of enforcement actions alleging reporting and other securities law violations by banks, savings and loan associations, and their holding companies and associated persons. The Commission cooperates with bank and savings and loan regulators in these investigations. For instance, the Commission's staff obtains information and documents from bank and savings and loan regulators regarding their examination of the financial institutions under investigation. Moreover, the Commission, upon request, routinely grants the banking authorities access to its non-public investigative files.

The Commission uses this information to enforce vigorously the securities laws in matters involving inadequate loan loss reserves, related party transactions, and other improper activities by financial institutions and related persons. For example, in SEC v. Financial Corporation of America, No. 87 Civ. 2578 (D.C. Cir. filed Sept. 21, 1987), the Commission sought permanent injunctive and other equitable relief against a savings and loan holding company, alleging that the holding company had violated the reporting, books and records, and internal controls provisions of the federal securities laws. Without admitting or denying the Commission's allegations, the holding company consented to the entry of a permanent injunction and other equitable relief. In In the Matter of American Savings and Loan Association of Florida, 5/ the Commission and the Federal Home Loan Bank Board (the "FHLBB") issued a report of investigation and order pursuant to Sections 15(c)(4) and 21(a) of the Exchange Act and Section 407(e) of the National Housing Act with respect to American Savings and Loan Association of Florida ("ASLA"), a Florida savings and loan association. The report stated that ASLA violated the reporting provisions of the federal securities laws by failing to disclose in its press releases, in reports filed with the FHLBB, and in shareholder reports material information related to certain repurchase

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5/ Securities Exchange Act Release No. 34-25788 (June 8, 1988).

transactions. The order required ASLA to comply with certain disclosure provisions of the Exchange Act and to comply with its undertaking to require outside securities counsel to review and approve its FHLBB disclosure filings and certain of its press releases. ASLA consented to the report and order, without admitting or denying any of the allegations.

The Commission also brought an administrative proceeding against the holding company of Continental Illinois National Bank and Trust Co. of Chicago. 6/ The Commission alleged that Continental mischaracterized a substantial portion of the loan loss provision reported in its quarterly report for the second quarter of 1984. Continental consented to a Commission order directing it, among other things, to comply with various provisions of the Exchange Act, and to restate its financial statements. In In the Matter of Texas Commerce Bancshares, Inc., 7/ the Commission found that Texas Commerce Bancshares, Inc. ("TCB"), a bank holding company, had failed to have in place an adequate loan loss review system, and that as a result, the consolidated loan loss reserve for TCB, as of December 31, 1984, was understated by $28.2 million. TCB consented to the issuance of an order requiring it to comply with the reporting, books and records, and internal controls provisions of the Exchange Act, and to comply with certain undertakings.

E. Proposed Securities Law Enforcement Remedies

On January 18, 1989, the Commission submitted to Congress a legislative proposal to amend the securities laws to authorize new types of enforcement remedies. This bill has been introduced in the Senate as S. 647 by Chairman Dodd and Senator Heinz, and in the House of Representatives by Congressman Dingell as H.R. 975.

The amendments would authorize the Commission to request that federal courts impose civil monetary penalties for violations of the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940. The Commission also would be authorized to impose civil penalties of up to $100,000 per violation by individuals and up to $500,000 per violation by others in certain administrative proceedings under the Exchange Act, the Investment Company Act, and the Investment Advisers Act. The proposal would also expressly authorize a court to suspend or bar a violator of the federal securities laws from service as an officer or

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6/ In the Matter of Continental Illinois Corporation, Accounting and Auditing Enforcement Release No. 128 (Feb. 27, 1987).

7/ Accounting and Auditing Enforcement Release No. 146 (Aug. 17, 1987).

director of any reporting company, and would provide the Commission with similar authority in proceedings under Section 15(c)(4) of the Exchange Act. Finally, the proposal would add violations of Section 16(a) of the Exchange Act as bases for administrative proceedings under Section 15(c)(4) of that Act. Section 16(a) imposes stock ownership reporting requirements on persons owning more than ten percent of any class of equity security registered pursuant to Section 12 of the Exchange Act and on officers and directors of issuers of such securities. The amendment to Section 15(c)(4) would provide the Commission with an administrative remedy to address Section 16(a) reporting violations that may not warrant an injunctive action. Expansion of remedies such as those contained in this bill and in the recently enacted Insider Trading and Securities Fraud Enforcement Act of 1988 will create additional need for increases in enforcement staff and support budgets because defendants and respondents may be more likely to litigate.

III. MARKET REGULATION

A. Workload

In recent years, there has been an explosive growth in the number of broker-dealer firms. From 1980 through 1989, there was an estimated 88% increase in the number of registered broker-dealer firms, from 6,750 to 12,700, and an estimated 145% increase in the number of registered representatives, from 196,000 to 480,000. During the same period, the Division of Market Regulation's staff years actually declined, from 268 to 244. Adequate supervision of the financial services industry is essential for the protection of investors and for the maintenance of investor confidence in our nation's capital markets. The Commission needs additional resources to ensure that the Division can perform its supervisory and related functions in the face of these dramatic increases in its workload. The Commission's broker-dealer examination staff will also need additional resources to ensure that it can continue to detect abusive sales and trading practices. In particular, increased examination staff is needed to increase the number and scope of cause examinations of firms engaged in blank check offerings and in the secondary trading of penny stocks; to conduct more extensive reviews of firms' retail pricing practices and in-depth assessments of their "Chinese Wall" procedures; and to enhance the analyses of customer accounts to detect excessive trading and churning. In addition, as contemplated by recent changes to the Exchange Act, the increased examination resources are needed to ensure that broker-dealers maintain appropriate supervisory procedures to prevent insider trading.

At the Commission's urging, the self-regulatory organizations ("SROs") have been devoting greater resources to their supervisory responsibilities. In recent years, there has been a

significant increase in the size of the self-regulatory organizations' staffs. The four largest SROs (in terms of regulatory staffing) are the New York Stock Exchange, the American Stock Exchange, the Chicago Board Options Exchange, and the National Association of Securities Dealers. From 1985 to 1989, the number of staff persons devoted to surveillance, examinations, enforcement, and general regulatory programs at these SROs increased approximately 32%, from a total of approximately 1,254 persons to approximately 1,654 persons. During this period, the number of staff persons devoted to these programs increased 47% at the New York Stock Exchange, 32% at the National Association of Securities Dealers, 17% at the American Stock Exchange, and 8% at the Chicago Board Options Exchange.

This increase in SRO resources has enhanced the SROs' ability to detect suspicious sales and trading activities, and to enforce their rules against member firms and associated persons. While this increase in SRO activity has complemented the Commission's enforcement efforts, there is still a need for increased Commission enforcement resources. Large components of the Commission's enforcement program, such as cases involving financial disclosure or accounting, cases involving investment companies and investment advisers, and most cases involving fraudulent securities offerings, are unaffected by the increase in SRO activity. Moreover, even in the broker-dealer area, the jurisdiction of the SROs is limited to member firms and their associated persons. For example, an SRO may proceed against a broker-dealer or a registered salesperson involved in insider trading, but not against a customer involved in the same activity. Accordingly, the continued high level of referrals from the SROs necessitates additional Commission resources to ensure that the agency can investigate and, when appropriate, bring enforcement actions with respect to these referred matters.

B. Proposed Capital Markets Unit

The extraordinary changes to the securities markets during the past decade have profoundly influenced the broker-dealer business. Today, many broker-dealer firms concentrate a substantial amount of their capital in complex trading strategies involving securities, futures, currencies, and interest-rate swap vehicles. Moreover, the major firms now generally conduct business as part of a larger holding company complex that includes numerous unregulated affiliates.

These complex trading strategies and the activities of the unregulated affiliates could expose firms to increased risk of failure that could cause a significant disruption of the financial markets. Accordingly, it is essential that the Commission's staff be able to assess the extent to which broker-dealer firms are exposed to market, credit, and other risks associated with an increasingly global mix of business activities. The Division of

Market Regulation thus has proposed the creation of a capital markets unit to monitor the risk exposure of major securities firms and their unregulated affiliates. This unit would permit the Commission better to anticipate where a significant risk to the U.S. financial markets or U.S. customers might arise and to increase the ability of firms and self-regulatory organizations, as well as of U.S. and foreign government agencies, to address risk. The unit would also be designed to foster increased cooperation and information sharing among international banking and securities supervisory agencies.

C. Commission Recommendations Regarding the October 1987 Market Break

In October 1987, the nation's securities and stock index futures markets underwent an extraordinary surge of volume and price volatility, culminating in a steep and abrupt decline on October 19 and 20, 1987. The Division of Market Regulation prepared a comprehensive study of these events. The staff's report found that no single factor -- economic, structural, or psychological -- was responsible for the size and breadth of the market break. It concluded that rapid, large stock and futures sales by institutions, while not the sole cause of the market break, were significant factors in accelerating and exacerbating a decline triggered by changes in investor perceptions regarding investment fundamentals and economic conditions.

In June and July 1988, the Commission submitted to Congress a series of legislative proposals to address issues raised by the October market break. The Commission's legislative proposals included the following areas of particular concern:

First, the Commission concluded that uncertainty about the total risk exposure of participants in the stock, options, and futures markets exacerbated conditions during the market break. It therefore recommended that it be authorized to establish reporting requirements for registered broker-dealers regarding the activities of their affiliates that are likely to have an impact on their financial or operational condition.

Second, the Commission determined that SRO surveillance and trade reconstruction efforts would be enhanced by the development of information systems for large stock transactions. It therefore recommended legislation to require reporting of such transactions. This authority would enable the Commission to create a reporting system that would increase its ability to identify and monitor activities that are likely to affect the equities markets.

Third, the Commission concluded that it was imperative to move to a more coordinated credit, clearance, and settlement system across markets. Accordingly, it recommended legislation

specifically directing the Commission and the Commodity Futures Trading Commission to facilitate the goal of integrated cross-market clearance and settlement systems.

Fourth, the Commission proposed that it be granted authority to take a number of different kinds of actions to respond to market emergencies. This authority, similar to that currently held by the CFTC, would, among other things, enable the Commission to make margin changes, delay openings, close markets early, and temporarily halt trading.

Chairman Dodd and Senator Heinz have introduced these four legislative proposals in the 101st Congress as S. 648, and Congressman Dingell has introduced them as H.R. 1609.

D. Municipal Bond Disclosure

The Commission is concerned about the current quality of disclosure in certain municipal bond offerings, especially in light of changes in the market for municipal securities. At the time the securities laws first were enacted in 1933, most municipal securities offerings involved general obligation bonds that were primarily sold to institutions within a limited geographic area. Since 1933, however, the municipal markets have become national and now include a broader range of investors. In addition, municipal financings have become increasingly complex, with a greater proportion of revenue bonds that may pose greater credit risks to investors because they are not backed by the full faith and credit of a governmental entity. Further, more innovative forms of financing have focused increased attention on call provisions and redemptive rights.

The preparation and timely dissemination of official statements, in conjunction with a careful review of the issuer's disclosure by the underwriters, are important disciplines that benefit the participants as well as investors. In addition, with the increase in novel or complex financings, there may be greater value in having investors receive disclosure documents describing fundamental aspects of their investment. Underwriters are unable to perform this function effectively when offering statements are not provided to them on a timely basis. Moreover, where sufficient quantities of offering statements are not available, underwriters are hindered in meeting present delivery obligations imposed on them by rules of the Municipal Securities Rulemaking Board ("MSRB").

For these reasons, on September 22, 1988, the Commission proposed Rule 15c2-12, 8/ which would require that underwriters

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8/ Securities Exchange Act Release No. 26100 (Sept. 22, 1988), 53 Fed. Reg. 37778 (1988).

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of municipal securities offerings exceeding $10 million obtain and review a nearly final official statement before bidding on or purchasing the offering. The rule also would require underwriters of a municipal offering exceeding $10 million to contract with the issuer or its agents to obtain final official statements in sufficient quantities to permit delivery to investors in accordance with MSRB requirements and, depending on the time of the request, to make available a single copy of the preliminary and final official statement to any person on request. In addition, the Commission published an interpretive statement emphasizing the responsibility of municipal underwriters to have a reasonable basis for believing in the substantial accuracy of key representations contained in the official statement, as well as any other recommendations that they make regarding the offering.

If this rule is adopted, the Commission will have greater inspection and enforcement obligations in the municipal securities field, requiring additional resources.

IV. FULL DISCLOSURE

A. Workload

The number of disclosure filings received by the Commission has grown substantially. From 1980 to 1988, there has been a 135% increase in the number of registration statements filed each year under the Securities Act, from 710 to 1,671, and a 175% increase in the number of merger proxies filed, from 140 to 385. During the same period, filed tender offer schedules increased 663%, from 104 to 794, and filed annual reports have increased 37%, from 8,344 to 11,443. Further, transactions and securities under review have become more novel and complex, and often raise difficult legal, financial, and accounting issues. The internationalization of the world's securities markets also has created many issues for the Commission's disclosure staff. This increase in the complexity of the staff's activities, as well as the dramatic increase in disclosure filings, necessitate additional staff resources.

B. Leveraged Buyouts

The Commission is currently devoting significant attention to leveraged buyouts ("LBOs") and other takeover activities. In an LBO, assets of the subject company are used as collateral for a loan that is obtained to pay all or part of the purchase price of the company or to accomplish a restructuring of the

company. 9/ The federal securities laws are designed to provide the subject company's shareholders with information concerning the transaction in which they are asked to sell their securities. The disclosure concerns generated by highly leveraged transactions, however, reach beyond the interests of the subject company's shareholders and affect holders of senior debt securities, purchasers of the debt securities issued to finance the transaction, and equity participants in the surviving entity. The Division of Corporation Finance is exploring possible rulemaking and interpretive initiatives to ensure that investors receive adequate information. In addition, investment vehicles that allow small investors to participate in these transactions indirectly and on a diversified basis through so-called "junk bond" 10/ funds and business development companies formed to invest in LBO securities, or through employee stock ownership plans, may raise significant disclosure and, in the case of funds, inspection concerns. Further, the potential effect on banks, thrifts, insurance companies, broker-dealers, and investment banking firms that may finance these transactions must be considered.

Management-led leveraged buyouts ("MBOs") raise particular policy concerns. In an MBO, management, either alone or, more typically, in conjunction with a group of outside investors (usually an LBO firm), acquires the company from its public stockholders in a going-private transaction. 11/ Management can have an inherent informational advantage over nonaffiliated shareholders and is presented with a conflict of interest when dealing with the corporation's shareholders. The Commission has adopted an extensive and detailed disclosure system to address these issues and is currently monitoring its effectiveness. In addition, state law has developed substantive and procedural protections for shareholders against conflicts of interest in these transactions. The Commission's staff will be exploring proposals to expand or modify the scope of current rules to

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9/ See Leveraged Buyouts and the Pot of Gold: Trends, Public Policy, and Case Studies, A Report Prepared by the Economics Div. of the Congressional Research Service for the House Subcomm. on Oversight and Investigations of the Comm. on Energy and Commerce, 100th Cong., 2d Sess. (Dec. 1987) (Comm. Print No. 100-R).

10/ The term "junk bond" refers to high-yield, non-investment grade bonds. Because they carry more risk, junk bonds, which are also sometimes referred to as "high yield bonds," must pay a higher rate of interest to attract investors.

11/ A "going private transaction" is a transaction by the issuer or affiliates which results in the elimination of public ownership of a class of equity securities.

assure that they address current market practice, and will continue to monitor state law developments.

The Commission's Office of Economic Analysis ("OEA") and Division of Corporation Finance are gathering data on, and analyzing, the LBO phenomenon in order that Congress and the Commission may assess the policy implications of these transactions. In response to a January 6, 1989 request from the Senate Banking Committee, OEA has collected data describing 142 leveraged buyouts during 1984-1988 that had transaction values of at least $100 million. The Division and OEA are examining, among other things: (1) the adequacy of disclosure in these transactions; (2) the sources of financing; (3) the effects of the transactions on stock and bond prices, profits, cash flow, effective taxes, asset sales, employment and wages, research and development, and capital expenditures; (4) management participation in these transactions; (5) fee structures; and (6) the returns obtained in "reverse LBO" transactions in which a company that had been taken private seeks to become publicly-held again. The results of these efforts will be presented to Congress and will provide the basis for discussion of potential Commission initiatives.

C. Status of EDGAR

The Commission is moving ahead with its development of a fully operational EDGAR (Electronic Data Gathering, Analysis, and Retrieval) system. EDGAR is the Commission's program that enables registrants to file documents with the Commission electronically, via a computer link. Implementation of operational EDGAR will accelerate dramatically the filing, processing, dissemination, and analysis of time-sensitive information filed with the Commission. Under EDGAR, when information is electronically filed with the Commission it will be accessible to investors, the media, and others on personal and business computer screens in minutes, instead of days and weeks.

On January 3, 1989, the Commission awarded the EDGAR contract to the BDM Corporation, with Mead Data Central, Inc., Sorg Incorporated, and Bechtel Information Services as subcontractors. The contract has an expected term of eight years. The initial three years will be on a cost reimbursement plus fixed fee basis; the last five years will be on a fixed price basis. Phase-in of filers will begin in mid-1990 and is expected to be completed in 1993.

The North American Securities Administrators Association ("NASAA") has indicated that state securities regulators want the same direct, on-line linkage to the EDGAR system that the Commission examiners will have. The Commission has offered to provide NASAA a direct feed of state-related electronic filings which NASAA could distribute to the states via their own

computer facility. If the states were given the direct access they request, there would be additional costs to the Commission associated with this link. The magnitude of these costs is uncertain at this point.

Currently in its fourth year of operation, the EDGAR pilot program has demonstrated the feasibility of electronic filing and review procedures. More than 40,000 electronic filings were made between September 1984 and the 1988 fiscal year end.

D. Regulation of Banks and Savings and Loans

As part of its plan to reorganize the savings and loan industry, the Administration has proposed that all securities issued by banks and thrifts to the investing public, with the exception of deposit instruments, be made subject to the registration requirements of the Securities Act, and that administration and enforcement of disclosure requirements with respect to such entities be transferred to the Commission. These proposals are substantially similar to the recommendation of the Bush Task Group on Regulation of Financial Services that the securities registration and reporting requirements of all publicly-owned banks and thrifts be transferred to the Commission. If this proposal is adopted, the Division of Corporation Finance will need additional staff to administer those requirements for banks and savings and loans.

E. Legislative Initiatives

On March 17, 1989, Chairman Dodd and Senator Heinz introduced as S. 651 the Trust Indenture Reform Act of 1989, which was first proposed by the Commission in November 1987. Congressman Rinaldo introduced this bill in the House as H.R. 1786 on April 11, 1989. This legislation would modernize the Trust Indenture Act of 1939, which regulates the public issuance of debt securities and the relationships among security holders, indenture trustees, and obligors. The legislation also would broaden the Commission's exemptive power to allow for variation from the Act's requirements in appropriate circumstances. In recognition of the character of an indenture trustee's legal duties and the realities of trust practice, the bill would make technical conflicts of interest irrelevant to a trustee's eligibility prior to default. To promote the internationalization of public securities markets, the bill would also permit the Commission to allow foreign trustees under qualified indentures in certain circumstances.

The Commission has also supported legislation to reduce the period for filing an initial beneficial ownership report under Section 13(d) of the Exchange Act from ten days to five business days and to prohibit the filing person from acquiring additional securities until the required filing is made with the

Commission. 12/

V. INVESTMENT MANAGEMENT REGULATION

A. Increase in Regulated Entities

In recent years, there has been a tremendous growth in the number of investment companies and investment advisers and in the assets they manage. From the end of fiscal year 1980 through fiscal year 1989 the percentage increase in the number of registered investment companies is estimated to be 146% (from 1,461 to 3,600), while the percentage increase in the number of registered investment advisers is estimated to be 217% (from 4,580 to 14,500).

Despite this industry growth, the Commission's examination staff has not significantly increased since 1980 because of budgetary constraints. This has resulted in a decline in the percentage of registrants inspected. The average inspection period for investment companies during 1989 is expected to be once every 4.7 years, and, even assuming anticipated staff increases in 1990, the average inspection period is expected to be once every 4.2 years. The Commission's inspections of investment advisers now occur, on the average, once every 12 years and should only improve to 11.1 years if the staff increases contained in the 1990 budget request are forthcoming.

The Commission's investment management program also faces a number of challenges presented by industry growth, more diverse financial products, and greater internationalization. Investment companies and investment advisers invest in numerous complex financial products, such as interest-only and principal-only portions of debt securities, foreign currency forwards, Euro-bond options, limited partnerships, and securities backed by credit card receivables, car loans, and other assets. The examination of such complex products requires highly skilled examiners and specialized inspection techniques. Moreover, some investment companies regulated by the Commission invest in foreign portfolio securities, have foreign advisers or subadvisers, and keep custody of securities overseas. The practical problems associated with regulating these entities require that the Commission enter into cooperative arrangements with foreign regulators to conduct joint compliance examinations.

12/ See Statement of David S. Ruder, Chairman of the Securities and Exchange Commission, Before the House Subcommittee on Telecommunications and Finance, September 17, 1987; Statement of Charles C. Cox, Acting Chairman of the Securities and Exchange Commission, Before the Senate Committee on Banking, Housing, and Urban Affairs, June 23, 1987.

In addition, these and other new products, internationalization, and other market developments have required the Commission staff to consider many more and increasingly complex requests for exemptive relief from the stringent requirements of the Investment Company Act.

B. Public Utility Holding Company Act

Due to budgetary constraints, the Commission's staff is having difficulty meeting its responsibilities on a timely basis under the Public Utility Holding Company Act of 1935. The staff is responsible for reviewing filings made under the 1935 Act and for acting on applications for exemptive relief. The types of complex issues that the staff is analyzing and anticipates continuing to review in the foreseeable future include sales and leasebacks of utility assets in amounts that may individually exceed one billion dollars, creation of holding companies in order to facilitate diversification, nonconventional financings by utility companies in order to fund existing nuclear utility projects, increased diversification by registered holding companies into nontraditional utility areas, involvement in cogeneration and independent power production projects in order to compete with non-1935 Act regulated businesses, and accounting standards and practices that conflict or may conflict with those of the Federal Energy Regulatory Commission. Recently, many of the largest public utility holding company systems in the United States have expressed their desire for prompter response by the staff to exemptive and rulemaking requests. Without increased appropriations, however, it will not be possible to eliminate significant existing backlogs in exemptive and rulemaking requests.

C. Shareholder Communications Improvement Act of 1989

On March 17, 1989, Chairman Dodd and Senator Heinz introduced in the Senate the "Shareholder Communications Improvement Act of 1989" as S. 649. This legislation would extend the benefits of the Commission's shareholder communication rules to investment company beneficial security holders. These rules now require brokers and dealers, banks, associations, and other entities that exercise fiduciary powers holding securities in nominee name to deliver proxies, consents, and authorizations to the beneficial owners and to supply registrants, upon request, with beneficial owner information so that registrants can send annual reports and voluntary communications directly to beneficial owners. S. 649 would also require that registered investment companies provide information statements to security holders in connection with meetings of security holders if management is not soliciting proxies, consents, or authorizations. The bill would also provide that nominees must deliver information statements to beneficial owners of investment

company securities and securities registered under Section 12 of the Exchange Act.

VI. LEGAL SERVICES

The increased level of Commission enforcement activity, particularly in the insider trading, financial fraud, and broker-dealer regulation areas, has generated a heavy caseload for the Office of the General Counsel. This Office reviews proposed enforcement actions to ensure policy consistency, adherence to recent court developments, and appropriate resolution of novel legal issues. The General Counsel also represents the Commission in the appellate courts when decisions in judicial or administrative enforcement proceedings are appealed, and litigates disciplinary actions against attorneys and accountants under Rule 2(e) of the Commission's Rules of Practice. Each of these activities increases as the level of activity in the Commission's enforcement program increases.

With respect to appellate litigation, the Office represents the Commission both in appeals involving Commission enforcement cases and as amicus curiae in private actions raising significant issues under the federal securities laws. In fiscal year 1988, the Supreme Court considered three important cases in which the Office filed briefs. In United States v. Carpenter, 108 S. Ct. 316 (1987), the Supreme Court affirmed by an equally divided court the Second Circuit's adoption of the Commission's misappropriation theory of liability in an insider trading case. In Basic, Inc. v. Levinson, 108 S. Ct. 978 (1988), the Supreme Court adopted the Commission's positions that preliminary merger negotiations are, under some circumstances, material, and that an investor-plaintiff may show reliance under the fraud-on-the-market theory. In Pinter v. Dahl, 108 S. Ct. 2063 (1988), the Supreme Court adopted the Commission's position as to the availability and scope of the common law in pari delicto (equal fault) defense in actions by investors under Section 12(1) of the Securities Act of 1933 for rescission of the sale of unregistered securities. The Court also largely adopted the Commission's position as to who can be liable as a "seller" under Section 12(1).

Court of appeals litigation arising from Commission enforcement actions requires the Office to brief an extraordinarily wide range of issues, as defendants in Commission litigation exhibit an increasing propensity to assert novel theories. For example, this Office successfully represented the Commission in a circuit court case challenging the Commission's authority to bring civil enforcement actions. Blinder Robinson & Co., Inc. v. SEC, 855 F.2d 677 (10th Cir. 1988), cert. denied, 57 U.S.L.W. 3552 (Feb. 21, 1989). The Office also recently represented the Commission in its successful opposition to a petition for a writ of mandamus, which was filed by certain defendants in SEC v. Drexel

Burnham Lambert Inc., et al., No. 88 Civ. 6209 (S.D.N.Y. filed Sept. 7, 1988). The petition had urged that the Court of Appeals for the Second Circuit order the district judge to recuse himself from the case.

In addition, the Office litigates the Commission's disciplinary proceedings against professionals, including attorneys and accountants, under Commission Rule 2(e). Recently, the Commission has increased the number of these proceedings, which are complex, fact-intensive, and typically involve multiple respondents and issues, expert witnesses, and computerization of a large number of documents. For example, one important case prosecuted by the Office is In the Matter of John M. Schulzetenberg, C.P.A 13/, in which, after presentation of the staff's case-in-chief, the respondent consented, without admitting or denying the Commission's allegations, to a Commission opinion and order finding that he had engaged in improper professional conduct as an auditor. The Commission's opinion sets forth its views of the obligations of an auditing firm's engagement partner to adequately plan and supervise an audit. An increased number of financial fraud investigations by the Division of Enforcement has correspondingly increased the number of these disciplinary proceedings against accountants.

The Office's Adjudication Group is responsible for preparing the Commission's opinions in its administrative enforcement proceedings (other than those under Commission Rule 2(e)) and in appeals from self-regulatory organization disciplinary actions. Two particularly significant administrative opinions of fiscal year 1988 were In the Matter of Adrian Antoniu, Securities Exchange Act Release No. 25169 (Dec. 3, 1987) (appeal pending), and In the Matter of the Application of E. F. Hutton & Company, Inc., Securities Exchange Act Release No. 25887 (July 6, 1988). In Antoniu, the Commission upheld the decision of an administrative law judge barring an employee of a registered broker-dealer from association with any broker-dealer based on his conviction for insider trading. E.F. Hutton was a significant case initiated by the National Association of Securities Dealers on the duties of broker-dealers handling customer's open limit orders when the broker-dealer is also making a market in the stock.

The Office is also responsible for defending the Commission in suits challenging the Commission's rulemaking and administrative orders. For example, the Office is representing the Commission in connection with a petition for review of the Commission's Rule 19c-4, which requires the delisting of companies which take certain steps to disenfranchise their

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13/ Accounting and Auditing Enforcement Release No. 200 (Sept. 23, 1988).

shareholders. Business Roundtable v. SEC, No. 88 Civ. 1651 (D.C. Cir. filed Sept. 2, 1988).

The Office also has experienced a significant increase in its non-litigation activity. The Office reviews rulemaking proposals and other significant regulatory actions for consistency with statutory standards and compliance with applicable administrative law requirements. In the legislative area, the Office assists in the preparation and consideration of proposed legislation and Commission testimony before Congress, and responds to Congressional inquiries into issues such as leveraged buyouts and tender offer legislation, insider trading and other enforcement legislation, Glass-Steagall Act amendments, and financial reporting reforms. For instance, the Office rendered substantial technical assistance to Congress in drafting the Insider Trading and Securities Fraud Enforcement Act of 1988. The Office also prepared the proposed "Securities Law Enforcement Remedies Act of 1989" and participated in the preparation of the Commission's proposed "International Securities Enforcement Cooperation Act of 1989."

VII. INTERNATIONALIZATION

Increasing internationalization is one of the most significant recent developments in the securities markets. This development poses significant challenges for the Commission, including the need to adapt regulations and to expand enforcement capabilities to ensure the Commission's ability to protect U.S. investors in the internationalized marketplace.

A. International Securities Enforcement Cooperation Act of 1989

On March 1, 1989, the Commission submitted to Congress a legislative proposal, entitled the "International Securities Enforcement Cooperation Act of 1989." Chairman Dodd and Senator Heinz have introduced this bill in the Senate as S. 646, and Congressman Markey has introduced it in the House of Representatives as H.R. 1396. This proposal would enhance international cooperation in the enforcement of securities laws. The Commission submitted a substantially similar legislative proposal to the Congress in June 1988, part of which was enacted by Congress as Section 6 of the Insider Trading and Securities Fraud Enforcement Act of 1988. 14/ Section 6 amended the Exchange Act to permit the Commission, in its discretion, to provide foreign securities authorities with assistance in investigating possible violations of laws or rules related to securities matters that the requesting authority administers or enforces.

14/ Pub. L. No. 100-704, 102 Stat. 4677.

S. 646 includes three provisions of the June 1988 proposal that were not enacted, as well as two new provisions. In order to facilitate the cooperation of foreign authorities in providing the Commission with investigative assistance, the proposal would exempt confidential records obtained from a foreign securities authority from disclosure requirements under the Freedom of Information Act or other laws. Access for Congress, however, would not be affected. The bill would also make explicit the Commission's rulemaking authority to provide nonpublic documents and other information to foreign and domestic authorities. S. 646 would also amend the Exchange Act, the Investment Advisers Act, and the Investment Company Act to authorize the Commission, based upon the findings of a foreign court or foreign securities authority, to censure, revoke the registration of, or impose employment restrictions upon securities professionals registered to do business in the United States. Finally, the bill would amend the Exchange Act to include a felony conviction as a basis for disqualification from membership in a self-regulatory organization and to permit the Commission to accept reimbursement, from or on behalf of a foreign securities authority, for expenses incurred by the Commission in carrying out investigations for that authority or in providing other assistance.

B. Disclosure Initiatives

The Commission recently has taken several initiatives with respect to disclosure requirements for international transactions. For instance, on June 10, 1988, the Commission proposed Regulation S, 15/ which is intended to clarify the extraterritorial application of the registration provisions of the Securities Act. The regulation would clarify that the registration provisions do not apply to offers and sales of securities outside the United States, and would provide safe harbors for offers, sales, and resales of securities; following the objective procedural standards of the safe harbors would assure that the registration requirements would not apply. In addition, the Commission has proposed a new Rule 144A 16/ that would provide a safe harbor exemption from the Securities Act registration requirements for specified resales of securities to institutional investors. Foreign issuers who may previously have foregone raising capital in the United States due to cost and liability concerns may find private placements in this country a more viable option if proposed Rule 144A and proposed Regulation S are adopted. The Commission's staff also is developing an

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15/ Securities Act Release No. 33-6779 (June 10, 1988), 53 Fed. Reg. 22661 (1988).

16/ Securities Act Release No. 33-6806 (October 25, 1988), 53 Fed. Reg. 44016 (1988).

initial multi-jurisdictional registration experiment with Canada. These and other Commission initiatives designed to address issues raised by the internationalization of the world's securities markets will continue to require substantial staff resources.

C. Elimination of Trade Barriers in the European Community by 1992

The European Community 17/ has adopted a program to develop a single internal market for the Community's goods, services, capital, and labor by the end of 1992. Establishment of such a single market will require the removal of numerous barriers between member states, and the potential transfer of significant regulatory authority from the member states to the European Community. In the securities area, the Community has proposed or adopted directives concerning such matters as stock exchange listings, offering prospectuses, open-end mutual funds, and interim reporting and accounting requirements for certain companies.

Although it is difficult to predict what effect the completion of the European single market will have on the United States, it is possible that removal of barriers to the free flow of capital between member states will allow U.S. securities firms and investment companies to compete more effectively in some European markets, and will open those markets to capital-raising efforts by U.S. issuers. However, it is also possible that the Community will create standards of financial regulation that differ from those existing in the United States. The Commission continues to monitor the program of financial regulation in the European Community with the aim of protecting U.S. investors and promoting the ability of U.S. firms to compete fairly overseas.

D. IOSC Annual Conference

The Commission is a member of the International Organization of Securities Commissions ("IOSC"). IOSC members take turns hosting an Annual Conference, and the Commission has agreed to host the IOSC Conference in 1991. The authorization request includes $100,000 to cover possible Commission costs associated with the Annual Conference.

VIII. GLASS-STEAGALL REFORM

The Commission supports modification of the Glass-Steagall Act, provided that adequate safeguards are enacted to address the

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17/ The member states of the European Community are Belgium, the Federal Republic of Germany, France, Italy, Luxembourg, the Netherlands, Denmark, Ireland, the United Kingdom, Greece, Spain, and Portugal.

investor protection concerns arising from increased bank securities activities. The Commission believes that investors will be adequately protected if banks that engage in securities activities are subject to the same regulations, enforced by the Commission, as are all other entities engaged in those activities.

S. 1886, the "Proxmire Financial Modernization Act of 1988," was passed by the Senate in the 100th Congress. The legislation would have allowed affiliates of commercial banks to underwrite and deal in most securities. To address the significant investor protection concerns raised by the expansion of bank securities activities, Titles III and IV of S. 1886 incorporated amendments to the federal securities laws that were negotiated between the Commission and the bank regulators. Title III would have limited the existing bank exclusions contained in the Exchange Act so that specified securities activities would be subject to Commission regulation. Title IV would have amended the Investment Company Act and the Investment Advisers Act to address concerns arising from bank entry into the investment company business. The bill was referred to the House Banking, Finance and Urban Affairs Committee and the House Energy and Commerce Committee, but the 100th Congress recessed without the House taking action on this legislation.

On January 31, 1989, Senator Dixon introduced in the Senate S. 305, the "Proxmire Financial Modernization Act of 1989." This bill is identical to S. 1886, with a few minor modifications. On the same day, Chairman Dodd introduced in the Senate S. 308, the "Financial Modernization and Safe Bank Act." Chairman Dodd's bill, like S. 305, would expand the securities powers of banks. S. 308 would require that a bank holding company create a securities affiliate if it wished to engage in these expanded powers. The Commission is currently reviewing these legislative proposals.

IX. PROGRAM DIRECTION

A. Administration

Program Direction consists of two major functions -- one, policy management which encompasses policy formulation, information dissemination and management of agency resources, and two, administrative support which provides data processing, logistical, staffing, and financial services necessary to support the agency's mission. As the workload of the operating divisions increases, so does the workload of the Executive Staff. It is important that adequate resources are available to keep up with other agency activity so that Commission policy is developed and applied consistently.

The newly created Office of Inspector General will need additional resources to implement the amendments to the Inspector General Act passed in fiscal year 1989. The audit coverage of Commission programs and data processing operations will be significantly increased to promote economy and efficiency. Evaluations of systems and controls will be emphasized to comply with recently revised government auditing standards. Also, the Inspector General will conduct new internal investigations and other activities.

B. Computerization

The high degree of automation in the securities industry has accelerated during the last 20 years, and the trend toward automation continues. Automation has dramatically changed every facet of the securities industry. The markets themselves have significantly upgraded their automated systems, ranging from data dissemination to order routing, trading, clearance, and settlement systems.

The Commission must likewise devote substantial resources to automated surveillance and regulatory systems. Four of the major areas that the Commission must address are the need for (1) expanded capacity to track diverse yet interrelated securities markets, both domestic and foreign; (2) increased sophistication in tracking and analyzing operations at individual securities firms and their impact on the markets; (3) enhanced systems to evaluate the effectiveness of the self-regulatory organizations' surveillance and monitoring programs; and (4) systems for nationwide registration of broker-dealer registered representatives and of investment advisers.

Periods such as the October 1987 market break have demonstrated the necessity for the Commission to expand its capacity to gather up-to-the-minute information electronically, not only in the nation's securities and futures markets, but also in foreign markets. While the Commission has undertaken several initiatives in this area over the last two years, increased sophistication in the use of outside systems, as well as the Commission's internal information systems, must be a high priority.

C. Salary and Resource Levels

In each of the last six fiscal years, registration, transfer, and other fees have significantly exceeded the Commission's budget, due largely to increased market activity. The Commission received $249 million in 1988 fee revenue, as compared to its appropriation of $135.2 million. Estimated fee collections of $252 million are expected in 1989, as compared to the agency's appropriation of $142.6 million, and $263 million in 1990, as compared to the agency's requested funding of $168.7

million. In contrast to the sharp increase in fees collected and dramatic increases in the Commission's workload, total staff years will remain almost flat during the period 1980 to 1989, from 2,041 to 2,050, based on the most current estimate.

The Congress has recognized the Commission's resource problems, and, at the request of this Subcommittee, the Commission's staff undertook an examination of the agency's staffing problems and the alternatives available to address these concerns. In the study, the staff found that the agency needs special new authorities in order to attract and retain quality staff. Five specific recommendations were developed to accomplish this goal. They are:

- set staff salaries that would take into account competitive salary differentials and would provide regional pay differentials;
- offer retention bonuses to professional staff based on performance;
- fill 100 positions at compensation up to level IV of the executive pay scale for highly qualified lawyers, accountants, or other professionals for specific cases or program management;
- develop and implement pay bands for classifying professional and support staff positions; and
- obtain authority for the Commission to lease space itself and obtain exemptions from GSA space management regulations in order to meet specialized Commission space requirements.

Since these proposals would involve a substantial cost to the agency, the staff study (as to which the Commission itself has expressed no view) offers three options for increased funding, including two special funds that would provide monies for the Commission's operations, subject to Congressional oversight.

D. Effect of Budgetary Freeze Proposals on Commission's Obligations and Objectives

The invitation to Chairman Ruder to testify before the Subcommittee included a request for information with respect to the effect the various "freeze" proposals would have on the Commission's staff levels, as well as on its ability to meet its statutory obligations and current goals and priorities. The Commission understands that two principal budgetary freeze proposals have been discussed. One proposal would keep the 1990 Commission appropriations at the 1989 level, $142.6 million, and

the other would reduce the 1990 appropriations below the 1989 level.

Either proposal would seriously impair the Commission's ability to meet its statutory objectives. Certain expenses that will increase in 1990, such as civil service salaries and employee health benefits, are not within the Commission's control. Consequently, maintenance of the Commission's 1990 appropriations at the 1989 level would necessitate a $1.5 million reduction in non-personnel expenses and a $6.6 million reduction in personnel expenses. The reduction in personnel expenses would result in a loss of 132 staff years by the end of 1990, which could be achieved through an absolute hiring freeze and normal attrition. A reduction in the Commission's funding level in 1990 would require even more extreme measures, such as involuntary personnel reductions, early retirements, mandatory unpaid leave, and permanent dismissals.

These freeze proposals, and the consequent reduction in staff, would seriously impair the Commission's ability to carry out its statutory responsibilities and meet its current objectives. The Commission is already suffering from a shortage of resources, and an additional reduction would further hinder the Commission's efforts. In particular, a freeze would reduce the Commission's ability to enforce the securities laws, to inspect and supervise regulated entities, and to review disclosure filings. Consequently, such a freeze would not be in the interest of investors or the securities markets.

To avoid these consequences, the Commission urges that the Congress and the Executive craft a budget compromise that addresses the budget deficit while permitting continued effective enforcement of the nation's securities laws. Needless to say, if the Commission's budget is reduced, the Commission will take whatever steps are feasible to continue effectively to enforce the securities laws with less manpower and resources. 18/

18/ Commissioners Fleischman and Cox concur in the desirability in general of each of the several programs described in this Testimony and in the inevitable logic of an Authorization Request directed to the accomplishment of such programs, but do so with two serious reservations arising from Gramm-Rudman-Hollings mandates: first, that the Testimony fails to explain why an exception should be made to across-agency "freeze" proposals so as to result in less impairment of the Commission's ability to fulfill its particular statutory objectives than of the ability of other affected executive and regulatory agencies to meet the responsibilities of their respective governing statutes; and, second, that the Testimony fails to explain which of the several programs,

(continued...)

* * *

We appreciate this opportunity to present the Commission's 1990-1992 authorization request.

18/(...continued)
present or prospective, claims what rank among the Commission's priorities in addressing the multifold statutory objectives for which it has been made responsible.

In addition, Commissioner Fleischman questions the omission of any request for funds for a study of the nation's capital markets, authorized in late 1988 by Pub. L. No. 100-704.

Senator DODD. Thank you very much, Mr. Chairman.

And I mentioned the size of your statement. It is a very comprehensive statement and one that I found very worthwhile in going over in that you outline in detail your responsibilities.

Let me begin and I will keep an eye on my time here, and give Senator Heinz an opportunity to jump right in. In fact, if I talk about some things that you are interested in, John, just jump right in anyway. We will try to cover some ground that way.

The President's budget asks for appropriations for the SEC in the amount of $168.7 million for 1990.

I would like you—I know this is a bit delicate, but we are going to have to make a strong case. In fact, the Budget Committee is meeting as we are meeting, and I just saw Chairman Sasser, and they are going right now, debating this issue of whether or not it ought to be a sequestered budget or the proposal as it reached agreement a week or so ago with the bottom line numbers.

But the SEC's budget is not normally the subject of the large budget debate, even though obviously the authorization of the budget targets for the SEC are important. We don't want to come out of that process with a number that is unrealistic that will not allow us to get the authorization or the appropriation figure we are seeking here.

So while I realize these are delicate questions to some degree, because from time to time they do put people at odds with the administration, it is important, very important that you should give me an assessment of just what the SEC should have as an optimum funding level.

Now, I am not talking about a cop in every corner, and you are not either. I know that. But what is the most cost effective level, the level at which the agency's presence will deter illegal activity and permit you to detect and prosecute serious law violations?

COMMISSION FUNDING

Mr. RUDER. Well, this year the President's 1990 budget of $168 million amounts to a substantial increase over the $142.5 million which we had appropriated in 1989, and we believe that the President's budget as submitted would provide us a substantial increase in our resources. We have given you an additional $10 million of increases which we believe are necessary to bring the figure to $178 million for 1990.

In 1991 and 1992, for which there is no Presidential budget figure, we would ask for very significant raises, as I have indicated, primarily in numbers of positions for the Commission. If we were to have what we need in 1991 and 1992, we would add almost 900 positions to the authorized positions for the Commission and would bring our total authorized staff positions 1992 to 3,471 positions with 3,271 staff years.

That is a very significant increase over our current year, an increase which I think would bring us to where we need to be to meet the burdens on us at this time.

Senator DODD. I used the word "optimum" levels, and you avoided using that word, but are you satisfied that the numbers that you have given us for 1990, 1991, 1992—that if those numbers are

reached that you will be able to reach your optimum levels so that you can detect and prosecute law violators?

Mr. RUDER. Well, it is delicate to respond to these kinds of questions. We made a request to OMB—which I think I can use to respond to your question—which was larger than the response that we received from OMB, but we are satisfied that, in this year of budget constraint, if we were to receive the $168 million in the Presidential budget plus the $10 million in new activities which we think need to be absorbed to get us to the $178 million figure, that would be a figure which we could live with for this year, for 1990.

"Optimum" is a peculiar word in response to that, but we are aware of the budgetary difficulties.

And I might put it a little differently to you, sir. If we were forced to live with a budget freeze for 1990, it would be pure disaster for us.

Senator DODD. Then you anticipated my next question. Anything below 168.7 you would describe as pure disaster?

Mr. RUDER. That is not really where I was going. If we tried to live with a $142.6 million appropriation, we would have to, for 1990, absorb approximately $8 million in pay raises and other mandatory increases, which would require us to essentially have full hiring freezes and reduction in staff of 132 staff-years; that is, if we merely receive what we had in dollar figures in 1989.

My own view is that in order for the Commission to perform efficiently and well for 1990 we need the full $168 million that is in the President's budget and the extra $10 million which we have included in our authorization request.

It is very hard to quantify our needs, but that is my personal opinion as to what we need.

Senator DODD. Anything less than the $168 million becomes a serious problem. If you get down to $142 million——

Mr. RUDER. It is disaster at $142 million. At $152 million it is terrible, and as it moves up toward $168 million it becomes satisfactory, but not optimum.

Senator DODD. OK.

In your testimony you state that budget limitations were a factor in the SEC deciding not to bring an enforcement action in the largest municipal bond default in our history, the Washington Public Power Supply System's $2.5 billion default.

It was stated directly that it was a question of having the resources to pursue the case. The implication was that the case was just too big. At least that is how I read it last night.

Mr. RUDER. Yes, sir.

Senator DODD. Are certain cases too big for the SEC to handle? What were the considerations that caused you to back away from the WPPSS?

Mr. RUDER. It was in part a resource allocation question. I would say that there were three aspects.

One was that the litigation issues were not as clear as we would like to have them.

The second was that there was a mammoth civil lawsuit going on with class action plaintiffs in which we had word that the number of dollars already spent in discovery before trial was well into the $100 million range, and so we knew that those issues were being

tried on the civil side, with private plaintiffs, which gave us some sense of relief.

But quite important was the fact that we would be dealing with a suit of that size with a staff which had other things to do, including the penny stock fraud area, including the Drexel Burnham case, and including, I might say, some other very highly complex and heavily litigated questions.

We are in complex litigation now with Stuart James out in Denver. We are in complex litigation with some other defendants, and it is important for us to have our resources available wherever we can spare them, and WPPSS just seemed like too large a case to justify resource allocation at that time.

Senator DODD. If you had had the additional resources—and you did not indicate where the staff-years, where those positions would go, but let's assume for a second you had those kinds of numbers—would you have pursued the WPPSS case?

Mr. RUDER. I don't really know. I would have to go back in time and look at the situation as it existed then. The numbers were so overwhelming at the time that there was no question, and I simply cannot tell you unless I went back what the resource allocation result would be at that time. I cannot give you a good answer for that.

Senator DODD. With respect to the numbers you are requesting, could you give us some indication where you intend to allocate them—how much of those resources you intend to direct toward the enforcement area, roughly?

Again, I don't want to nail you down with dotted "i's" and crossed "t's" unless you have that information, but you talked about 900 new positions if you got the 1991-92.

I jotted down some notes when you were mentioning it.

ADDITIONAL RESOURCES FOR THE ENFORCEMENT AREA

Mr. RUDER. A substantial portion of that would go to enforcement, in 1991, it is well over 100 people, I am told—but I must tell you that our staff is limited in all areas, and while the Enforcement Division is the investigative and litigating portion of the Commission, when I talk about market regulation and full disclosure and investment management, I am talking about inspection and review activities, which are really preliminary to bringing enforcement actions.

So in a sense, the whole Commission is an enforcement agency, and we need to be able to do the preliminary inspections and review before we can send matters to the Enforcement Division.

Although we would increase the enforcement staff by, I think, 100 to 150 people over the next 2 years, we would want to increase the remainder of the Commission as well.

Senator DODD. You indicated, of course, in the WPPSS case that you declined to bring that one for a number of reasons, not the least of which was the staff allocation, resource allocations.

But you devoted 35 staff-years to the Drexel case, and you have indicated that this case will continue to drain staff resources.

Let me turn to the April 17, 1989 issue of Business Week, and I want to quote their editorial to you.

"Keep the Milken Case in Perspective" was the title of the editorial in Business Week.

And referring to Milken's salary, it said: "The size of the numbers involved has tended to blow perspective on this case."

It then noted the savings and loan crisis, the scandal in the Pentagon procurement cases, the penny stock scandal, which has already been referred to here by my colleague from Pennsylvania, and it said:

> In parceling out our scarce resources for fighting white collar crime, far more systematic abuses that are clearly harming the taxpayers or investors cry out for greater attention.

How do you answer that editorial?

Mr. RUDER. Well, if that editorial is suggesting that additional resources are needed for the Commission to do its job, I would agree with it. If it suggests that we have been doing a poor job now, I would disagree with it.

I think we are doing a good job in our work. One of the problems that we have, I think, is that as we do a good job and as we turn up wrongdoing, we both increase the resources that we need to follow up on in our investigations, and we don't elicit the kind of crisis mentality for increases in funding that one does when one doesn't do a good job.

Senator DODD. I read this editorial as suggesting somehow that here you have focused on one individual, whereas there are systematic problems, and the question is are 35 staff-years allocated to one individual—and they suggest because he had a large salary——

Mr. RUDER. If that is—I am sorry, please go on.

Senator DODD [continuing]. Maybe others read it differently. That is how I read it.

Mr. RUDER. If that is the question, then I must tell you that our investigation of Drexel Burnham, which I think is best illustrated by the 19-count complaint which we filed, is a complaint against the firm, a complaint against four individuals, and indicates what we believe is a rather systematic activity within that firm led, according to our complaint, by one person and several others.

Senator DODD. Let me ask you, Mr. Chairman. You and I have talked about this privately, and it is a case that is going to be before the courts, but I think there is an assumption as people read the articles that we are dealing with some Robinhood here. People at Drexel made a lot of money, but there are questions about the SEC's allegations—what is wrong, other than some parking violations, that reach to the American taxpayer, that reach to the industry. Who is paying for what some of these actions allegedly involve?

I think there is a perception somehow that this is a few guys who did pretty well by the system, and now we are going to chase a few guys because they did well, and I don't think it has been made clear to the American public and others what the problem is here, what the alleged problem is.

Mr. RUDER. In short, the alleged problem is that the market for securities was manipulated, that there was insider trading, and that there was overt violation of the tender offer requirements which require disclosure of the size of positions.

All of those activities injure the market. They injure the market in the sense that the investors in the market are trading at prices which are artificial. The Commission came into existence in the 1930's for the purpose of dealing with market manipulation, and if the American public is convinced that the market is dishonest and manipulated, then the American public is not going to engage in market activities.

And I think that our suit in the Drexel situation has been aimed not at a single individual, but at the protection of the integrity of the market, and that is what that case is about, not having market manipulation, not having artificial prices, not having insider trading, and not having what we regard as blatant violations of the law. It is that arrogance, I think, that is something that the securities markets simply cannot countenance.

Senator DODD. Thank you.

Senator Heinz.

Senator HEINZ. Yes, Mr. Chairman.

I would like to explore the issue of penny stock fraud to determine whether your resources are sufficient to enable the SEC to deal with that activity.

I would like to get an idea of how big of a problem you think penny stock fraud is particularly because investors in that area are less sophisticated and less able to fend for themselves.

Now, it is my understanding that in many of the stock fraud investigations that have been conducted by the Commission there is a high degree of recidivism and that the same violators keep perpetrating frauds again and again. If that is true, why does that happen? Do you not have enough manpower? Don't you have the right enforcement authority?

PENNY STOCK FRAUD

Mr. RUDER. In the area of recidivism in securities law fraud, I would note that we don't have criminal law enforcement authority. What we have been doing is to work very carefully with the FBI and the Attorney General to see if we can't find a way to put these people in jail.

We have worked particularly in the Rocky Mountain area and in South Florida in task forces to provide a way to get at the recidivist securities law violators and put them away, and that is what I think needs to be done with those people.

The other half of it is that these recidivists have begun to employ a large number of either naive or greedy young people who are engaging in these boiler room activities, and these people need to know that we will bring suits against them, we will try to bar them from the industry, and we will publicize their wrongdoing as widely as we can, and it is in this area that we do need more resources.

Senator HEINZ. Do you need new authority to bar people from certain future activities, or do you have that authority?

Mr. RUDER. We have the authority. What we really need is a staff to litigate against rich manipulators, rich law violators, and I may say that we don't authorize our lawsuits lightly. We make a very thorough investigation and then our staff brings us cases

which we have every belief need to be brought. But when people are making millions of dollars in the market, they have millions of dollars to pay lawyers, and we find ourselves in exceedingly complex and highly litigated actions.

Senator HEINZ. If the SEC gets the additional resources requested in the budget that would bring it up to $178 million for fiscal year 1990, will that enable you to go after those penny stock fraud con artists and recidivists more aggressively?

Mr. RUDER. Yes—more aggressively.

Senator HEINZ. Or only marginally?

Mr. RUDER. More aggressively, sir. We have assigned a whole series of things to our penny stock task force—publicity, rulemaking, training programs, cooperation with other agencies—but the area is one in which we have not been able to move as powerfully as we would like to bring more actions.

We have plenty of investigations underway, and we need the resources to litigate those cases.

Senator HEINZ. Now, aren't many of these people just out and out crooks who should be put in jail?

Mr. RUDER. I believe that to be the case.

Senator HEINZ. You do turn some of these cases over to the FBI and the Justice Department.

Why aren't they able to put more of these people in jail?

It seems that they are right back in operation the next day.

Mr. RUDER. Some of them go to jail and come back out, but that is a different question. Some of them are barred for life in the securities industry and then end up as advisers and consultants and argue that they are not acting this way.

Until recently I don't think that we had captured the attention of the Justice Department, but I am pleased to tell you that Gary Lynch and I had a meeting with Attorney General Thornburgh, who indicated his interest in this area, and you may have read that he is assigning new slots for white collar crime, and I do think that you are going to see an increase in activities in the criminal area in that respect.

Senator HEINZ. Another area where the SEC has asked for congressional help has to do with large trader reporting. I have got two questions about that.

To what extent is your increased budget related to your ability to handle such reporting, if such reporting takes place?

TENDER OFFER REPORTING

Mr. RUDER. There is not a large increase in our budget to handle the reporting of large trading. We essentially need that to perform our oversight of the markets, both in terms of fraudulent activities and in terms of trying to be aware of where the large trading is in market crisis times, but the resources needed to utilize that information will not be great.

Senator HEINZ. So your argument for the need for large trader reporting is you have reason to believe that there are fraudulent practices taking place, and, second, you need it in order to manage the market or oversee the market properly in times of stress?

Mr. RUDER. That is right.

Senator HEINZ. Why is it that the SEC, rather than requesting legislation, can't obtain that kind of information under present law or require the NASD or any of the exchanges to obtain that kind of information pursuant to section 19(c) of the Exchange Act?

Mr. RUDER. The problem is that we have jurisdiction through our self-regulatory organizations to obtain trading records from the broker-dealers, and the broker-dealers will give us the name of the customer, but the customer is frequently a bank or a third party or some other entity which is not the real owner. So we do not have the power to find out who the real owner or the real trader of the securities is.

Senator HEINZ. Why can't you get the exchanges to do that? Why can't you tell the SRO's, look, this is what we need, please get it?

Mr. RUDER. The SRO's will say to that broker-dealer, give us the name of your customer, and the broker-dealer will say, our customer is X bank, and then the SRO will say to the broker-dealer, ask X bank who the customer is, and the X bank will say, I won't give you that information.

Senator HEINZ. There is a third step, isn't there?

Mr. RUDER. I suppose the third step would be for the broker-dealer to say, we won't do business with you unless you give us that name.

Senator HEINZ. That is the basis for all of the work that the SRO's do. The SRO's only work because they have the power to determine who is permitted to trade.

Mr. RUDER. That is right.

Senator HEINZ. On the exchanges?

Mr. RUDER. That is right, but I think at this point that the SRO's even would resist attempting to say to the broker-dealers you may not do business——

Senator HEINZ. They might, I understand. But that is not my question. My question is——

Mr. RUDER. Could we do that?

Senator HEINZ. Yes. Couldn't you do it? You might not want to do it by yourself. I am just asking whether you could do it by yourself.

Mr. RUDER. Yes, I guess we could say to the SRO's, your rule shall be that unless the broker-dealer gives you the name of the ultimate customer the broker-dealer may not trade on your exchange, but that is a kind of blunderbuss power that I think would interfere terribly with the operation of the markets.

Senator HEINZ. You are asking us to say that.

Mr. RUDER. No. We are asking you to give us the power to adopt rules so that there may be a way to force that information out of the individuals.

Senator HEINZ. This is probably the subject of another hearing, but I am not entirely clear what the difference is in terms of the end result. We can discuss that on another occasion.

Let me ask one other question about the SRO's.

Ideally, it would be desirable to have all national securities exchanges so organized and so imbued with the public interest that it would be possible and even desirable to entrust to them a great deal of the actual regulation enforcement within their own field, leaving the government free to perform a supervisory or residual role.

Those words were spoken by no less a figure than William O. Douglas.

Mr. RUDER. I was going to say that sounds like a quote from the 1930's.

Senator HEINZ. It is a quote from the third SEC Chairman, and later Chief Justice, 52 years ago in 1937. Your sense of timing is perfect.

The question is, do the sentiments of then Chairman Douglas reflect reality today? Can the SRO's in fact do more than they are doing today and thereby lessen the demands on you for direct supervision?

Mr. RUDER. I would like to tell you that one of the very positive things that I learned when I became Chairman was that during the last few years, particularly, the self-regulatory organizations have increased the size of their staffs dramatically and they have changed in some sense toward a more aggressive compliance attitude, and I am particularly pleased with the actions of the SRO's, including the NASD, in their enforcement efforts.

Now, one can always ask that things be better, and we have the responsibility of inspecting the SRO's, and each year we send them a rather long letter telling them in what respects we think their compliance operations can be improved.

But I have been reading those inspection reports, and I am really pleased to say that the efforts by the SRO's are really very good, and I think in that sense self-regulation is working.

Senator HEINZ. I tend to agree with you on that. My question was directed not so much to whether the SRO's are doing a good job, but whether they could do more of the job? Whether they can, in effect, be a replacement for some of the resources that you would like to have, probably over and above that which you have requested.

Mr. RUDER. I can give you two answers. One is that the more investigative and compliance work the SRO's do, the more referrals we get from them. So that, with regard to disciplining broker-dealers they may do that disciplining themselves but with regard to actions against individuals who are not registered, those referrals will come to us. So the better their compliance, the greater the strain on our resources.

Senator HEINZ. Are there any functions that the Commission now performs that you considered, are considering, have considered, or might consider at some future time requesting the SRO's to assume?

Mr. RUDER. There are three areas that I think you should know about.

One is that we are engaged in what is called electronic blue sheeting, which is a method of getting directly from the broker-dealers, in electronic form, an indication of trading by the brokers, and that information will come to SRO's but will also be available to us. We are giving the SRO's the major responsibility of doing that.

Second, we are working with the NASD on a program to see whether it will provide a central repository for registration of all broker-dealers and investment advisors in the United States, and we think that would be a very good result.

I think probably the most important initiative that is being discussed now at the staff level would be the creation of an SRO in the investment advisory area, and if we were to create an organization which would have responsibility for policing investment advisors, just as we have an organization to police broker-dealers, we might well save Commission resources.

Senator HEINZ. You have anticipated my last question which I wanted to ask you: whether that was under consideration. You said it is.

What timetable, if any, do you have for moving ahead with it?

Mr. RUDER. It is under serious consideration at the staff level. In preliminary discussions with the staff. I have indicated my enthusiasm for that project, and we expect to have a staff recommendation up sometime this summer.

Senator DODD. This is on the SRO under financial planners?

Senator HEINZ. Yes.

Mr. RUDER. Yes.

Senator DODD. As early as this summer?

Mr. RUDER. We hope so, this summer, yes.

Senator DODD. You answered my questions. I'm getting rid of my questions here.

Mr. RUDER. It will require legislation, of course, from Congress, but since the staff is behind it you can be assured it will reach the Commission level.

Senator HEINZ. If that kind of authority is forthcoming will that alleviate any burdens you now have?

Mr. RUDER. Yes, certainly in the investment management area. Based on discussions with my Director of Investment Management, I believe we would need something like 80 additional people to do our inspections today. But if we could have those inspections handled by an SRO it would relieve our burden enormously.

Senator HEINZ. On a different subject, the Commission recently approved the applications of several Exchanges—Philadelphia, American and the Chicago Board of Options—to list for trading market products known as index participation.

You and I have discussed these over the years. It seems, and indeed it has been I think, pretty close to 2 years that we have discussed them.

The Merc in Chicago and the Board of Trade promptly sued the Commission, alleging that these products are futures and therefore should be regulated instead by the Commodity Futures Trading Corporation. Do you believe that legislation is necessary to solve this jurisdictional dispute?

Obviously I hope not. I hope it can be solved, and promptly. But last year you proposed legislation to transfer jurisdiction overall stock for derivative products to the SEC. Is that still your view?

INDEX PARTICIPATION

Mr. RUDER. Let me answer both of those questions.

I think there are two questions with regard to IP's, index participations, proposed by the three Exchanges. We have issued a release, and we think that these are securities, and we expect to have

a court hold that these are securities. And, if they are securities, then of course we will not need legislation.

If the ruling should be that they are futures and not securities, I think that the result from a policy point of view would be very bad because it would effectively mean that these products would not be traded.

Senator HEINZ. How long will it take before we get the answer through the courts?

Mr. RUDER. I would not give you an answer——

Senator HEINZ. Will we all still be either at the SEC or in the Senate when we get that answer?

Mr. RUDER. The real question will be resolved early when the court decides whether or not to grant various stays for trading of the product.

Senator HEINZ. It will be an early test.

Mr. RUDER. In a procedural way, which will give some indication of which way the court may be heading. But even then I couldn't predict or say that the procedural determinations actually will predict the outcome.

Senator HEINZ. Are you saying that you would want to withhold a request for legislation that you made last year until this is settled, or not?

Mr. RUDER. My own personal view remains, as it has been, that proper regulatory resolution of the jurisdictional matters would be for the SEC to have power over derivative products.

But I believe, as I have said many times, that as long as we can have cooperative regulation between the CFTC and the SEC to solve our problems then we don't need to push that legislation. We are in a good cooperative mode with the CFTC.

Senator HEINZ. I notice that the CFTC has not joined in the Merc's and Board of Trade litigation.

Mr. RUDER. We had a substantial negotiation with the CFTC with regard to whether they would agree with our position. They did not.

But I am not aware of whether or not they plan to file a brief in support of these Exchanges.

Senator HEINZ. One last question, Mr. Chairman.

Senator DODD. Go right ahead.

Senator HEINZ. The big news last week was that the Commission reached a settlement with Drexel, Burnham, Lambert, and I noted at the same time that there was criticism from some quarters that the settlement was far too lenient, especially compared to the more draconian measures that you apparently employed against much smaller firms.

Now, that is not to say that $650 million is a drop in the bucket. It represents a significant penalty in absolute terms.

But critics have said that it doesn't appear to have had a particularly adverse impact on Drexel's continued operations and that it seems to be business as usual at Drexel where, in contrast to the fate of small firms, the Commission has attempted to close them down if fraud is or was pervasive. The critics, therefore, say that the Commission has fallen pray to the too-big-to-fail or close-down syndrome.

How do you respond to that kind of criticism?

Mr. RUDER. First of all, I would like to say that this settlement with Drexel is by far the most intrusive settlement that the Commission has had in its history with regard to any brokerage firm, except for those cases in which we have actually put a firm out of business.

We are going to be in a position of monitoring the activities of that firm in a way in which no one would willingly have agreed. And I think that the settlement, in terms of fulfillment of our responsibilities, is exceptionally good, and I am extremely pleased that ex-Chairman Shad is willing to assume the responsibility for oversight of that firm, and I am very confident that we will be able to exercise our responsibilities thoroughly.

If there is a charge against the Commission that it has failed to put a highly successful brokerage firm out of business, my answer is that——

Senator HEINZ. I'm not saying you should.

Mr. RUDER. I'm saying if there is a charge. I'm not saying you said that.

Senator HEINZ. Don't misunderstand me.

Mr. RUDER. Then my response would be that Drexel does play a positive role in the financial community and that we need to give that firm an opportunity to show that it will be an honest and law-abiding member of that community, and that is what we are going to be doing, especially over the next 3 years.

Senator HEINZ. I assume the answer is also that in small firms you just didn't see enough able and honest people to— in those that you closed down, enough able and honest people to justify their continued existence, and that was not the case with Drexel.

Mr. RUDER. I can put it a little differently.

Those firms did not have the resources to pay for new people to do their work, and Drexel is going to be paying for a law firm—I am sure, whose fees will not be small—to investigate their compliance operation and make recommendations for improvements.

They are going to be paying a team of accountants to go in there and examine their records at, I am sure, a cost of many millions of dollars in order that we may find out what has gone on and what will be going on in the future.

These are expenses which small firms can't bear.

Senator HEINZ. Mr. Ruder, thank you very much.

And Mr. Chairman, thank you for your generous time.

Senator DODD. There is a vote on the floor. We will proceed for a few more minutes here and then come back.

Let me move, if I can, to the internationalization of securities matters, and I've got a series of questions here.

Senator Pressler.

Senator PRESSLER. I cannot return, but I did want to ask my question.

What do you advise me, as a Senator, to do in this public interest question that I raised earlier. Japonica Partners is attempting to acquire one of our major railroads in the Midwest. They probably are after the land.

Northwest Airlines, which serves South and North Dakota, is a monopoly already. Eighty percent of the slots at the Minneapolis-St. Paul Airport are controlled by Northwest.

I know that you're not in a business of regulating transportation, but we have complete strangers showing up whose motives are unknown, whose intentions are unknown.

We're going to have to legislate somehow or do something about this situation. As a Senator, I'm not going to stand still. How do we go about controlling the acquisition of public transportation systems? Is there anything your agency can do? Is there any legislation we should pass regarding these takeovers so that the public interest can be taken into consideration?

ACQUISITION OF PUBLIC TRANSPORTATION SYSTEMS

Mr. RUDER. Well, sir, our agency has essentially been industry-neutral in terms of public policy issues. We are charged with a very broad responsibility concerning corporations in general and takeovers in general, but without a specific responsibility with regard to any industry.

So, in that sense, I think if you have a concern with respect to takeovers in the transportation area that would require special legislation—and probably not legislation which would be within the Commission's jurisdiction.

A second answer I can give you is that we do have very strict disclosure regulations on takeovers, and we would expect if the issue were brought before us to insist that the disclosures regarding the purpose of a takeover were made fully and adequately so that we could know what the intent of the bidder was for a corporation in a takeover situation or in a merger situation.

Senator PRESSLER. I'm sure from a corporate point of view we are beginning to see a situation in airlines where in a few years we may be down to our having only four or five airlines. Also, the public interest, whether it is in the Midwest or elsewhere, has reached a point that you can get only a little information on what is about to take place.

In terms of what their intentions are and what the public interest is, we have reached a point that some of these giant takeovers and takeovers in general are just going to be unacceptable to the American public, and I am not one for regulation.

I was elected on a platform of less government. But I am afraid that we are going to have to reverse ourselves in these areas. Now, would it be legislation that would be administered by the SEC? What would you recommend if you were advising one in trying to address this problem?

Mr. RUDER. We would of course enforce any laws which were given to us as a responsibility.

But I would think not. I would think that laws dealing with the transportation industry would be more normally regulated by the Department of Transportation.

Senator PRESSLER. I guess that presently is the case. If somebody who is not involved in transportation comes along to take over one of these companies, the ICC and the Department of Transportation

do not become involved. That, as I understand it, is a gap in the law.

That is not your fault. I am not saying that, at all, but I just wanted you to know and everybody to know that one Senator who is rushing off to a vote is very concerned this morning, especially about the Northwest Airline takeover, which has a monopoly in North Dakota, South Dakota, and Minnesota.

Also, TWA is a monopoly down in the St. Louis Airport where it controls 78 percent of the slots.

We are reaching a point where something has to be done. I do not know why Japonica wants the Chicago-Northwestern Railroad. I think for the land, but I think the public has an interest in that also.

But I have been instructed to recess this hearing, and I must run to vote.

And Senator Dodd will be back momentarily.

Mr. RUDER. Thank you.

[Recess.]

Senator DODD. The subcommittee will come to order.

Mr. Chairman, I apologize to you for running in and out with these votes. It is rather difficult. My earlier promise that we wouldn't have many interruptions has not held up. Let me try and move along here with you, if I can.

I have some questions that I may just submit to you in writing because in fact, I think some of these questions are at least in part answered in your testimony.

But let me jump to an area of tremendous interest to me and I know to you, as well. That is the internationalization of securities markets. The increasing globalization of trading has raised significant regulatory policy issues. Your agency has also recently proposed legislation to facilitate enforcement activities in this area, and I want to ask your views on other questions in this area.

The first relates to competition. The first quarter of 1989 there were four Japanese securities firms ranked in the top ten underwriters of Corporate Debt and Equity. Nomura is No. 5; Diawa, No. 7; Nikko, No. 8; and Yamachai is No. 10. For non-U.S. underwritings, the four Japanese firms are at the very top, beating out even Merrill Lynch. A decade ago, most of us viewed the Japanese market and Japanese firms as relatively insignificant.

We have on the horizon, of course, Europe 1992—and you address at least part of that issue in your testimony—which could pose even greater competitive challenges for our securities industry.

Now, most Americans do not like the idea that we may be losing our competitive advantage in the manufacturing sector in a number of areas, whether it is automobiles or shoes, not that we necessarily are, but I think there is a sense that labor costs and other things do put us at a disadvantage in some areas and we fought hard to remain competitive.

But, I don't know anyone who understands or accepts the notion that somehow the United States ought to be taking a back seat to any market in the world in the area of financial services generally, and in securities particularly.

And I wonder if you might respond to what sort of regulatory policy issues that raises.

We attract, as the statistics indicate, a tremendous amount of capital into our markets from overseas. And there are tremendous numbers of businesses in this country who are seeking to be on the ground and operating when Europe 1992 occurs.

So, obviously, it is not in our interest to start talking about barriers at all here. But there are some fascinating questions that are raised and issues that must be addressed if we are going to be able to maintain our access to the foreign markets where we simultaneously allow access to ours and maintain ourselves as strong competitors, while also maintaining the necessary protections for investors.

There are a whole host of questions. 144A, for example. What do you give up in terms of disclosure and investor protection to get that in the private placement area?

We sort of streamlined the regulatory scheme of it to attract capital in those areas, but how do you balance those interests with your regulatory goals.

What sort of thought have you been giving to that?

INTERNATIONALIZATION OF SECURITIES MARKETS

Mr. RUDER. I think one has to look at the global competitive environment in which our capital markets are going to exist, and if there has been any change I think in the securities markets in the last 5 years, it has been the emergence of the globalization of securities trading.

We have had the "Big Bang" in London. As you have indicated, we have had the emergence of the Japanese as major participants in the financial services area. Those four Japanese brokerage firms are the largest firms in Japan and indeed are the only large firms in Japan, and they have a very strong position.

We have 1992 coming along, with the possibility that you will have a unified European community, and we need to be prepared. What we have been doing at the Commission has been trying to liberalize some of the disclosure areas in order to facilitate foreign issuers to come into our markets and that has included rule 144A initiatives.

It has included some discussion in our regulation S proposals for overseas offerings by U.S. companies. It has included some rule proposals regarding broker-dealer activities in the United States.

We are engaged in a whole host of regulatory activities in various areas, including the disclosure area. We are talking about multijurisdictional cross-border recognition of disclosure documents, particularly with Canada.

Senator DODD. Let me turn to the bill, S. 646, which Senator Heinz and I introduced.

In order to facilitate the cooperation of foreign authorities and provide the Commission with investigative assistance, the proposal would exempt confidential records obtained from a foreign securities authority from disclosure requirements under the Freedom of Information Act or other laws.

Is that really necessary? Congress would not be included in that, I quickly should add. We are sensitive to that.

Mr. RUDER. We have a power, under legislation passed last year, to use our investigative mechanisms to provide information to foreigner authorities who have interests in activities in the United States which affect their markets.

Senator DODD. Right.

Mr. RUDER. We are trying to get reciprocal legislation and authority from markets overseas in which we would like them to use their investigative authority to give us information.

What they are concerned about is that they will provide us with that information and although it will be confidential information when they get it, it would be brought here to the United States and then subject to public disclosure through the FOIA.

We think that legislation is necessary in order to make it clear that information will not be disclosed. And interestingly enough, it is our general counsel's view that the exceptions to FOIA are sufficient to protect that information when it does come here.

But somehow or other we don't have a very clear message to give to foreign governments to say, yes, here is a statement expressly providing an exception for SEC investigations, and we need that as a means of persuading other governments to give us what we want.

So, it is a matter, in a sense, of bargaining, and I don't think that the legislation is going greatly to increase the exceptions which already existed. It is a matter of making very clear to the foreign governments that this exists.

I don't mean to denigrate our general counsel, but they are not quite as willing to rely upon his opinion as they would be upon legislation.

Senator DODD. I don't want to take up a lot of time on this particular point.

I forget the exact language, but someone talked about sort of the lowest common denominator in the regulatory scheme of things, and he said it in two words, and I cannot remember the two words, where you end up sort of having an erosion of our regulatory scheme in order to compete with other markets.

Now, the U.S. has a meeting coming up that we are hosting. We have $100,000 on your budget request for the meeting.

Mr. RUDER. The International Organization of Securities Commissioners.

Senator DODD. Full disclosure was the reason we started the SEC in the first place in 1934. Shouldn't we be encouraging these other regulatory authorities to pursue full disclosure rather than having us sort of eroding full disclosure?

Mr. RUDER. In the Melbourne meeting of that organization last fall I presented a Commission-endorsed document on internationalization of securities markets and the regulation of it, and that document was an effort to encourage other jurisdictions to raise their standards to provide good disclosure, sound enforcement, including good anti-fraud laws, and sound structure.

We are working very cooperatively with securities regulators around the world to achieve those objectives. And I think that the trend is positive. We had insider trading legislation enacted. We

are getting more enforcement agreements. We are having concentration on the possibility of having more uniform disclosures.

I think that if we continue an active policy here we will avoid the race to the bottom and have a kind of a system world-wide which will give the honesty and integrity to world capital markets which have made ours so great.

Senator DODD. I agree. I think that is one of the reasons we have been successful and I think the industry indicates that as well by their support for your increase funding.

Let me tell you that I think the legislation with the International Securities Cooperation Act is an excellent piece of legislation. And Rule 144A—in fact, I addressed the private placement group in New York earlier this year when I learned I would be taking over this subcommittee.

They were very interested in that particular issue, and I understand their point of view—it will help attract that capital.

I just have the same concerns you do about it in terms of what we give up in that regard. But we will follow that with you carefully.

Mr. RUDER. All right.

Senator DODD. Now, I have a question here and maybe you would just like to take a couple of minutes and comment. Everyone talked about the October 1987 crash and whether the individual investor would come back to the market.

Well, it apparently hasn't happened. We see a greater percentage of the market share being owned by institutional investors which raises a whole set of other issues I would like to get into, and that is pension funds and what happens to them in the market.

But, are we saying good-by to the individual investor and, if that is the case, what are the implications of that? How important is it, in your view, to have individual investors or the small investors as they are sometimes called—although some of them are not very small? How important an element is that in our capital markets?

INDIVIDUAL INVESTORS

Mr. RUDER. In my opinion it is essential to the health of our capital markets that we have individual investors in the market, and I believe it is essential to our economy that we have individual investors able to amass wealth by investing in growing companies and even mature companies as equity participants.

So, in my view, anything we can do to encourage that participation is something that should be pursued.

Senator DODD. I hope we will keep that up. I think it is very important, and obviously investor confidence is extremely important.

Mr. RUDER. We like to think that our mission is to protect the capital markets, and that the better we are at protecting the capital markets the greater the confidence the public will have in the honesty of those markets and the greater their participation will be.

Senator DODD. I subscribe to that philosophy entirely. I think that is the whole issue and the organization to do that is the SEC.

I would like to pursue the notion with you at another date or time, or some sort of a forum on the individual investor and what

needs to be done. I appreciate what you have said. I have said the same thing and I know others have.

But apparently we are not seeing the prior levels of activity. Individuals are not coming back and I agree with you about their importance as an element in our capital markets and the soundness of those capital markets. But I think we need to do a bit more thinking about how we can encourage that and promote that. We've really got to pay more attention to it.

Mr. RUDER. One of the initiatives that I think is interesting is the effort to eliminate and stamp-out, if we can, penny stock fraud and manipulation because the small investors who are injured in that market are going to be out of the stock market forever.

Senator DODD. For many years to come.

Mr. RUDER. So if we can prevent that from happening——

Senator DODD. That is a good thought.

Mr. RUDER [continuing]. Then we would increase confidence.

Senator DODD. You mentioned in your testimony the SEC is currently collecting data on leverage buy-outs which has been a subject of Finance Committee hearings in the Senate and the Commerce Committee and Ways and Means Committee in the House.

Congressman Markey has been holding hearings on that side.

I mentioned at the outset of my opening remarks that we want to take a look at that issue as well, hopefully later this year, but I will ask a couple of questions here and you can respond to them.

One, what are your observations at this point about the LBO issue? Are there abuses in the area? If so, what can be remedied through rule making or through legislation? We are all talking about tax proposals, and so forth.

But you noted in your December testimony before the House subcommittee that you were considering various rules proposals to address potential abuses in the LBO process. And I would add quickly here, as well, since you went into the management buy-out issue in your testimony, I wonder if you would comment generally on that subject matter and where we are headed.

MANAGEMENT CONFLICTS OF INTEREST

Mr. RUDER. Regarding the management conflicts of interest, we are monitoring carefully state law conflict of interest developments and we believe at this point that the States are doing a good job in regulating this area. So we do not foresee initiatives with regard to our rules.

I expect to have at the Commission table sometime this summer a rule which would require disclosure of management positions and fairness opinions with regard to all negotiated transactions, not just transactions in which management is on both sides.

With regard to the economic staff study, we still do not have that study completed, but we are expecting to have results sometime in the early summer.

In more general terms, it has been the Commission view—we haven't had a vote on it, but I think the Commissioners agree and it certainly is my position—that the leveraged buy-out movement is related to the takeover movement and that the takeover and

tender offer movement by and large has been a mixed phenomenon in our country.

Some of the results have been very, very good. Some have been bad and highly disruptive. But my view is that it is very, very difficult to come up with legislation which will eliminate the bad and keep the good. More likely, the legislation will eliminate so much of the good that the results will not be worthwhile.

So my own current suggestion is that Congress should go very, very slowly with regard to efforts to hinder the LBO and takeover phenomenon.

Senator DODD. Well, those rule proposals do lead to potential abuses. You said by summer?

Mr. RUDER. Primarily in the disclosure area, but we think that is an area in which we do have a primary responsibility and we should be and are focusing on it.

Senator DODD. You're not looking at the MBO issue? That is one where you are going to leave it pretty much to the States?

Mr. RUDER. The key regulatory state of Delaware essentially has moved to the point that when a suggestion for either a management buy-out or a tender offer comes in that the company will essentially be put at auction.

And once the company is up for auction, then we believe that it is important that there be adequate disclosures.

Senator DODD. Not just adequate. I think they would raise to a heightened degree the importance of disclosure.

Mr. RUDER. Heightened disclosures, I would agree with you. Heightened in the sense of a need for more disclosure.

And then the conflict of interest laws do apply—and in Delaware at least we have the appointment of an independent committee of directors who will make the final decision.

And indeed in the RJR-Nabisco case the decision was taken out of the hands of management and put in the hands of an independent committee which certainly did achieve a dollar result for shareholders which was much better than management's initial proposal.

Senator DODD. Well, we have to watch it.

Has there been any more of that? Have we seen more of the MBO's recently?

Mr. RUDER. Not as highly publicized, and there has been some slowdown recently, but I don't see that there would be any decrease in the desire of management to take their companies private and become owners in the future.

So I would anticipate that phenomenon will continue.

Senator DODD. Let me jump back one second.

It just occurred to me, while I was sitting here listening to your response on the question that had to do with the question on the international enforcement mechanisms and maintaining the regulatory reach of the SEC, we're seeing——

Aren't we, some unique circumstances where institutions that the SEC presently has the authority to regulate acquire institutions in the international market that take them beyond the reach of both the SEC and the other regulatory agencies of this Government.

Mr. RUDER. I don't want to be specific, but there is one investment firm——

Senator DODD. I know which one you're talking about. I don't want to mention it either.

Mr. RUDER. It has apparently decided to engage in buying a bank in Europe and since the parent is a securities firm and not a bank, the bank authorities the banks don't regulate that foreign entity. And since we don't have power to regulate affiliates of broker-dealers we can't regulate them.

So you're going to have a U.S. parent owning a bank in Europe which is not regulated, in which the U.S. parent is not regulated at all here, and that is part of the whole series of I think very important regulatory problems which the United States is going to be facing with regard to how the European and worldwide communities regulate the financial entities and how we regulate them over here.

Senator DODD. I am familiar with the one you talked about and I presume that you're going to see an explosion of some of that activity because——

Mr. RUDER. We're going to see an explosion in automation. My view is in the next 5 years we're going to see worldwide trading of world class equity securities with 24-hour markets.

We are going to see linkages of various exchanges and linkages of clearing apparatus at a rate that, even though we think it is going fast now, my own belief is that I cannot imagine how fast it is going to be.

Senator DODD. I agree with you.

Let me move on quickly. I mentioned to you as well that we are going to look into some of the post crash legislation—I know that you like to call it post-break. We use different terminology, I guess. But there are a series of question and maybe I should go through the questions all at once because they interrelate, rather than asking one at a time.

As I said, last year we all know that the Commission proposed legislation to address certain problems that came to light following the October 1987 market break. The legislation was recently introduced at the Commission's request. In addition, you have been part of the President's working group on financial markets which was established to facilitate coordination among regulators on certain market issues following that break.

Last May the working group issued its interim report and testified before this committee. Do you know if the working group intends to submit a final report? That's No. 1.

And No. 2, I would like to know a bit how this group works. How often has the working group met since it testified here last May? In your view, is it meeting frequently enough to ensure an effective level of coordination?

And No. 3, in the hearing last May, Treasury Under Secretary George Gould said that the working group would meet to consider legislation proposed by the SEC and would make recommendations to Congress with respect to your proposal. I want to know if this has happened. Did the working group make a decision as a group about whether to support the legislation.

Now, those are the series of questions.

Mr. RUDER. I will answer it generally.

The working group did, as you have correctly indicated—meet actively during the period, roughly February to May last year, and we did promulgate an interim report. There are no current plans for a final report, as far as I know, but in the transition of the Presidency, it is my understanding that Secretary Brady, as Chairman of that group, intends to continue its existence.

We met once with Secretary Brady early on this year. The group did. We have not met since, but we have a meeting scheduled in early May, and we expect to pick up again and see where we are and review a whole series of things, including SEC legislative proposals and other matters.

I know we will be paying particular attention to settlement matters. The Commission has sponsored, with the CFTC's agreement, an initiative to deal with some of the highly technical legal issues in the clearance and settlement area.

But I expect the working group to continue and to be a positive force for coordination. I know of no suggestion at this time that it be disbanded or discontinued. I look for it to be less active, but nevertheless in existence, to try to meet the various problems that were identified after the market break.

Senator DODD. Of course there is always a scurry of activity after an event like that. But I think it is disappointing.

I must tell you that when we do set up these organizations, it is one of the reasons that I think people question whether or not when government says something it means it. Interim report clearly implies that there is going to be a final report.

The words alone indicate that the Group would be going a bit further than it did in May 1988. I am taking this opportunity with you in front of me. It isn't necessarily your responsibility, but I would like to see that matter pursued. I think it would be helpful.

I presume even though the CFTC and the SEC and the self-regulatory bodies have stepped in, and in fact, like the New York Stock Exchange when I spoke to the Board there a few months ago—and I commended them for steps that John Phalen and others took. They did a first class job, in my view, in coming right in and moving aggressively in that arena.

But my view is that since the working Group's interim report in May there have been plenty of opportunities to assess your proposals, and I presume you are still suggesting that legislation may be necessary.

Legislation that has already been introduced are the four pieces that we thought were important and relatively noncontroversial. We did not introduce the two controversial pieces, one dealing with margin and the one dealing with regulatory reorganization.

Senator DODD. Does Treasury support these initiatives?

Mr. RUDER. I believe Treasury will be supportive of it. I cannot tell you of these initiatives. I cannot tell you in detail that they are, but we have been waiting until Treasury's attention to the S&L crisis is finished or not quite so intense.

We think that one of the reasons for the May meeting is that we hope by that time those problems would be behind them and they

could look at the market programs. And I may say to you that in my own view this is not the time for one to be complacent about the operation of our capital markets.

I think particularly from the Securities and Exchange Commission's point of view that we have a responsibility to remain alert. One of the matters that we suggested in our testimony, both in the written testimony and in our budget authorization request, is the creation of a capital markets unit so that we can continue that responsibility.

Senator DODD. I commend you for that. I think it is a very good idea, and I should tell you Senator Heinz and I have written Secretary Brady on this matter. I think the working Group was set up for a purpose, and now things appear to be moving on in a very stable way, and we're not likely, some would suggest, to run into those problems again. But the proposals you have made I think are pretty good.

There is some controversy about a couple of points which you and I are both aware of, but nonetheless, I think overall they are excellent suggestions.

As I said in my opening statement, it would be helpful if we could get the working Group, as a group to either recommend, amend, do whatever they are going to do here.

So, may we hope to get some answers back.

Mr. RUDER. This may seem like a political answer to you, but, if I am confident that we would have the support of that group for the legislation, I will vigorously pursue the group's actions in this regard.

Senator DODD. I will hope——

Mr. RUDER. The negative of that is also there, I guess.

Senator DODD. I have a couple of more questions.

We have talked about the penny stock fraud issue, and I join with Senator Heinz, and again, your own testimony, in supporting the importance of pursuing that. I think you've wisely raised the importance of that issue when we talked about the individual investor.

The SEC's self-funding study submitted to the subcommittee proposed legislation to give the SEC authority to fix the compensation of its employees——

Now, I know no one here in the room is interested in this question at all. [Laughter.]

Notwithstanding the provisions of any law applicable to the classification of pay rates of employees of the United States.

Now let me serve you up a softball here.

You have talked about it and I happen to agree with you in this area, but how critical is this legislation?

SEC SALARIES

Mr. RUDER. The portion of the self-funding study that deals with salaries at the Commission is exceedingly important. We must compete for all of our staff with the securities industry and the securities bar, and the accounting industry. And the people who we want are those people who will be able to have exceedingly high salaries.

So then, in order to prevent enormous turnover, we really need an increase in pay levels. So that portion I regard as critical.

The other portion, the portion that deals with revision of the budget and procedure for the Commission I think requires a very careful look. I would like us to be in a position where we are not looked at as an unimportant little piece of the budgetary process.

I would like us to be in a position where our value is recognized and our funds are adequate. It is not of great personal interest to me how that happens, and if it can happen through the ordinary appropriations process, that would be fine.

If it need be that we get pushed a little bit to the side in order to accomplish that, that would be fine, as well.

So, as you know, the amount of money that is brought in by the Commission is greater by far than the Commission's budget. The funds—putting funds such as exist in the Drexel matter aside—that we raised for the U.S. Government is about $250 million, at least it was this last year, and the appropriations for fiscal 1989 is $142.5 million.

My view is that, as long as we need money, the amount that we bring in should be recognized, and it is part of that thinking that has led us to think that our funding should be analyzed carefully.

Senator DODD. I agree with you, and I think you will find some sympathetic ears on that point. I mentioned earlier Senator Hollings—it is extremely important and he is on the Appropriations Committee and the Budget Committee, and he feels very strongly about the fact that you generate about $100 million that comes in for filings and transaction fees.

I think there were some $67 million last year that were in civil penalties outside of the Drexel case, and $50 million that came in just in that one case alone.

Mr. RUDER. But the figure is $250 million for registration fees, transactions fees on the securities exchanges and in tender offer filings.

Senator DODD. $250 million. It was $100 million above the budget.

Mr. RUDER. Yes, above the budget.

And in addition, the $50 million from the Boesky settlement. And we think that, although the $300 million which Drexel will pay is technically going to come through the U.S. attorney's settlement with Drexel, our staff had substantial input in that case and that it would not be inappropriate for us in that particular instance to receive some recognition for the revenue generated.

Senator DODD. I would totally agree with you on that and I would presume they wouldn't disagree either.

Well, we have covered a lot of ground. And I should tell you that I agree with you about the fee issue and the salaries.

I had the unique distinction earlier this year of being one of five members of this body to express a need to get rid of the honoraria issue in exchange for raising salaries for not only Members of Congress, but the other people in Government, Federal judges, and high-ranking civil servants.

And I must tell you that even in the absence of that, I think it is remarkable how well your staff does. They are facing some of the highest priced, toughest lawyers this country produces.

The fact that we have good people who are willing to take the salaries that we offer in Government—and I know many of them are probably sought out on a daily basis to change camps and to move across the street, and the industry would be getting some fine people—the fact that they still stay on and believe very strongly about how important it is and that this fine agency that has served us so well for more than 50 years be kept working as effectively as it has and their names never appear in the papers——

Mr. RUDER. Except for Gary Lynch. [Laughter.]

Senator DODD. That bothers you? If that bothers you, we'll take care of that.

But, Congressmen, Senators go home. They stand up in these town meetings and they berate the mindless, faceless bureaucrat.

And I know when I drive out of here at night, rarely before 7 or 8 o'clock, there are an awful lot of lights on in this building. And I can drive by your building, and there are a lot of lights on in your building.

Nobody's punching a clock.

But that somehow gets lost in some of the rhetoric we hear time to time. So, I hope we can do something about it, not only because I think they deserve it, I think the country deserves it, and hopefully we can get beyond some of the talk show hosts on radio and get some people who understand the issue and are willing to stand up and explain it to their constituencies and how important it is.

So, I commend you for proposing it. We will do the best we can.

You understand as well as I do the realities of what we are up against in trying to bring down this deficit and to do so without increasing taxes. The President made that commitment and I think there is no appetite for that in Congress at this time.

We have a lot of important priorities in the country. This is one of them. We will do our best to meet your targets here for a budget that will allow you to perform effectively in the coming 2 or 3 years.

I want to thank you today for your testimony. I will include in the record the letters from the Securities Industry Association, as well as the National Association of Manufacturers. We will also leave the record open for additional submissions and questions from my colleagues who, due to the FSLIC debate, were unable to be with us this morning.

I want to thank you for your testimony. It was very helpful. We intend to have an aggressive subcommittee. We've got a lot of work in front of us. We think it is exciting to get into it and we think that we can educate ourselves on these very important issues. We don't have the legislation in every instance and I'm not interested in legislating for the sake of it.

We can use these forums to try to talk in common sense, plain, simple terms that the average American citizen can understand about how important some of these matters are.

I thank you for your presence here this morning, and you staffs, as well. We look forward to working with you.

Mr. RUDER. Thank you, and we look forward to working with you.

Senator DODD. The subcommittee will stand adjourned until further call of the Chair.

[Whereupon, at 1:06 p.m., the hearing was adjourned.]

[Summary of legislative proposals and copies of bills with additional material supplied for the record follow:]

Summary of Legislative Proposals

The following measures were proposed by the SEC and were introduced in the Senate on March 17, 1989 at the request of the agency. It is expected that at the April 18th hearing, SEC Chairman Ruder will testify on the need for each of these measures.

A number of these bills are controversial and will require additional hearings in the future, at which investor and business representatives, as well as other commentators, will testify. A more detailed discussion of the legislation together with the text of the bills may be found in the March 17, 1989 Congressional Record, pages S 3038 - 3054; S 3064 - 3068.

S.646 THE INTERNATIONAL SECURITIES ENFORCEMENT COOPERATION ACT OF 1989

This bill is designed to strengthen international cooperation in the enforcement of securities laws, so that U.S. investors will continue to be afforded the protection of our laws in an increasingly global trading environment. A nearly identical measure(except for two provisions noted below), S.2544, was introduced in the last Congress and was unanimously reported out of the Committee last July.

The legislation would further international cooperation among securities regulators by giving the Commission the authority to maintain the confidentiality of certain foreign evidence. The Commission has expressed concern that, in the past, negotiations of bilateral assistance agreements have been frustrated by the agency's inability to assure foreign authorities that documents and testimony they transmit to the Commission will be kept confidential, as is often required under their resident laws. The Commission currently has disclosure obligations under the Freedom of Information Act and pursuant to third party subpoenas. This legislation would exempt documents furnished to the Commission from disclosure if the foreign authority represents that the disclosure of the documents would violate confidentiality requirements of its country's laws.

The bill also would make explicit the Commission's rulemaking authority to provide documents and other information to foreign and domestic authorities.

In addition, the bill would amend the Exchange Act, the Investment Advisers Act, and the Investment Company Act to authorize the Commission, based upon the findings of a foreign court or foreign securities authority, to censure, revoke the registration of or impose employment restrictions upon securities professionals registered to do securities business in the United States. The Commission already has this authority as to illegal

or improper activity in this country, and it has imposed limitations on activities of securities professionals based upon the findings of a foreign court as to certain illegal activity abroad. This bill would make this authority explicit, and would add to the Commission's authority as well. The legislation would give the Commission authority to suspend or bar securities professionals who have made false filings with foreign authorities; who have been convicted of certain crimes by foreign courts(addition to S.2544); who have been enjoined by a foreign court from committing securities law violations; who have violated foreign securities laws; or who have aided and abetted such violations.

The legislation also would expand the grounds on which a self-regulatory organization could deny a person membership in, participation in, or association with a member of, the SRO. It would permit the Commission and the SROs to provide special scrutiny of persons who have been convicted of crimes that currently are not specified as grounds for denying a person membership, participation, or association with an SRO, such as drug trafficking, assault and other crimes.

The bill also would permit the Commission to accept reimbursement from a foreign securities authority for travel and other expenses incurred by the Commission in carrying out investigations for that foreign authority(addition to S.2544).

S.647 THE SECURITIES LAW ENFORCEMENT REMEDIES ACT OF 1989

This bill is designed to strengthen the enforcement capabilities of the Securities and Exchange Commission and enable the Commission to tailor enforcement remedies more appropriate for particular facts and defendants.

This legislation in large measure builds upon the philosophy underlying the Insider Trading Sanctions Act and subsequent amendments to that Act, which gave the Commission authority to seek civil penalties for insider trading violations. The bill would authorize the Commission to request that federal courts impose civil penalties for certain other violations of the federal securities laws. In addition, it would authorize the Commission to impose civil penalties in certain administrative proceedings under the Securities Exchange Act of 1934, the Investment Company Act of 1940, and the Investment Advisers Act of 1940.

In addition to the civil penalty provisions, the proposal contains three other new enforcement remedies. It contains express authority to provide that federal courts can, as ancillary relief in Commission injunctive actions, prohibit an individual from serving as an officer or director of any reporting company. It would permit the Commission to impose such

a prohibition in its administrative proceedings under Section 15(c)(4) of the Exchange Act, and it would give the SEC authority to bring administrative proceedings against officers and directors and principal stockholders for violations of the reporting provisions of Section 16(a) of the Exchange Act.

In its memorandum in support of the legislation, the Commission stated that the legislation was based in large part upon the Commission's response to certain recommendations of the National Commission on Fraudulent Financial Reporting, known as the "Treadway Commission." In addition, the Insider Trading and Securities Fraud Enforcement Act of 1988 directed the Commission to submit to Congress recommendations with respect to civil penalties and administrative fines.

The Commission has urged Congress to adopt this legislation on the basis that the additional sanctioning authority will enable the Commission to tailor enforcement remedies more precisely to particular facts, and thereby to maximize the effectiveness of its enforcement actions. In addition, the Commission has said the creation of more severe penalties would inject a greater general deterrence aspect into its enforcement program. The Commission currently does not have the flexibility in seeking or imposing civil money damages that several of the self-regulatory organization have. Finally, the Commission has urged that, by giving it express authority to impose corporate bars and suspensions, the legislation would resolve any doubts about the propriety of this remedy, which has been obtained in Commission injunctive actions by consent.

S.648 THE MARKET REFORM ACT OF 1989

This bill is designed to address potential gaps and weaknesses in current market regulation and market practices identified in studies by the Securities and Exchange Commission and others following the October 1987 market crash. The legislation was submitted to Congress by the Commission on June 23, 1988, as four separate provisions.

The four measures have been combined for the purpose of introduction as "The Market Reform Act of 1989."

Emergency Authority/Trading Halts. The legislation would provide the Commission with authority to take temporary emergency action without procedural delay in response to a major market disturbance. This authority would include, but not be limited to, the ability to alter, supplement, suspend, or impose requirements or restrictions with respect to hours of trading, position limits and clearance and settlement. This emergency authority could be exercised if there were a substantial threat of sudden and excessive fluctuations of securities prices generally that would threaten fair and orderly markets, or a

substantial disruption of the safe or efficient operation of the national system for clearance and settlement of securities. The Commission's action taken under this legislation would be subject to judicial review.

Large Trader Reporting. The legislation also would provide the Commission with authority to adopt reporting rules relating to large securities transactions and certain transactions in the futures markets that are related to transactions in the securities market. In its memorandum supporting the legislation, the Commission noted that this section is modeled after the large trader reporting authority of the CFTC. It is designed to assist the Commission in its surveillance of the U.S. securities markets by providing it with broad authority to adopt reporting rules for the purpose of monitoring the impact on the securities markets of large transactions in publicly traded securities involving a substantial volume or a large market value in equity index futures and options on such futures. The Commission could use information contained in the reports for surveillance, enforcement and other regulatory purposes.

Risk Assessment for Holding Company Systems. The legislation would expressly authorize the Commission to require certain entities registered with the Commission, including brokers and dealers, to report information relating to their associated persons that may have a material impact on the financial or operational condition of the registered entity. Under this legislation, the Commission could adopt rules requiring information concerning, among other things, assets, liabilities, contingent liabilities, material contracts, loan commitments, trading or investment positions, lines of credit, letters of credit, and financial guarantees. However, where information regarding the activities of banks, insurance companies, futures commission merchants and other regulated institutions is available to another supervisory agency, information would not be required under this provision. Moreover, the Commission would have exemptive authority.

Coordinated Clearing. The legislation would direct the Commission and the Commodity Futures Trading Commission, in consultation with the Board of Governors of the Federal Reserve System, to facilitate the establishment of linked, coordinated, or centralized facilities for clearance and settlement.

In its memorandum in support of the legislation, the Commission observed that the clearing systems for securities, securities options, futures contracts and options on futures, and commodity options affect the nation's financial systems. The clearing procedures employed for these products potentially can affect, through settlement default or lack of coordination with other clearing systems, other cleared products, clearing systems, and financial systems.

S.649 SHAREHOLDER COMMUNICATIONS IMPROVEMENT ACT OF 1989

This bill is designed to improve the flow of information to mutual fund and other investment company shareholders.

The legislation would extend to mutual fund and other investment company security holders the benefits of the Commission's shareholder communication rules which now require brokers and dealers, banks, associations, and other entities that exercise fiduciary powers holding securities in nominee name to deliver proxy materials to the beneficial owners and to supply registrants, upon request, with beneficial owner information so that they can send annual reports and voluntary communications directly to beneficial owners.

It also would require broker and bank nominees to transmit information statements to the beneficial owners of the securities. In addition, beneficial owners of investment company securities also will be included among those security holders to whom nominees must deliver information statements.

S.651 TRUST INDENTURE REFORM ACT OF 1989

This bill is designed to streamline and improve the disclosure requirements for the issuance of debt securities and enhance the protection of security holders. The legislation was first submitted to Congress by the SEC on November 17, 1987, and it was introduced at the request of the agency by Senators Proxmire and Garn on June 24th of last year.

The Commission developed this legislation for the purpose of modernizing the Trust Indenture Act of 1939, which currently regulates the public issuance of debt securities and the relationships among security holders, the indenture trustee and the obligor. Since the adoption of the current law, there have been significant changes in the markets, with respect to both the types of debt securities offered to the public and the techniques for their sale. As a result, the Commission has advised Congress that aspects of the Act have become administratively or substantively obsolete.

The Commission has further stated that this legislation would modernize the law while continuing to mandate necessary protections for debt holders. For example, while current law requires that indentures set forth certain mandatory requirements, this legislation would make those requirements self-executing by law, those avoiding unnecessary "boilerplate" language in disclosure documents.

The legislation would also give the Commission greater exemptive authority in order to permit the Commission to adjust requirements to particular needs when their application would impose undue restrictions and would be unnecessary to serve the purposes of the law. The legislation would make further revisions in the conflict of interest provisions of current law, as well as revisions affecting the qualifications of foreign trustees.

II

101ST CONGRESS
1ST SESSION

S. 646

To amend the Federal securities laws in order to facilitate cooperation between the United States and foreign countries in securities law enforcement.

IN THE SENATE OF THE UNITED STATES

MARCH 17 (legislative day, JANUARY 3), 1989

Mr. DODD (for himself and Mr. HEINZ) (by request) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

---

A BILL

To amend the Federal securities laws in order to facilitate cooperation between the United States and foreign countries in securities law enforcement.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; TABLE OF CONTENTS.

(a) SHORT TITLE.—This Act may be cited as the "International Securities Enforcement Cooperation Act of 1989".

(b) TABLE OF CONTENTS.—

Sec. 1. Short title; table of contents.
Sec. 2. Release of records by the Commission.
Sec. 3. Sanctions against broker or dealer, associated person, or persons seeking association.

Sec. 4. Definition of foreign financial regulatory authority.
Sec. 5. Sanctions against investment advisers or persons associated or seeking association with a registered investment adviser or investment company.
Sec. 6. Definitions of foreign securities authority and foreign financial regulatory authority.
Sec. 7. Reimbursement of expenses incurred in an investigation undertaken at the request of a foreign securities authority.

SEC. 2. RELEASE OF RECORDS BY THE COMMISSION.

Section 24 of the Securities Exchange Act of 1934 (15 U.S.C. 78x) is amended—

(a) in subsection (b) by striking "Nothing in this subsection shall authorize the Commission to withhold information from the Congress."; and

(b) by adding at the end thereof the following new subsection:

"(c) Notwithstanding any other provision of law, the Commission may, in its discretion and upon a showing that such information is needed, provide all 'records' (as defined in subsection (a)) and other information in its possession to such persons, both domestic and foreign, as the Commission by rule deems appropriate if the person receiving such records or information provides such assurances of confidentiality as the Commission deems appropriate.

"(d) Notwithstanding the provisions of Section 552 of title 5, United States Code, popularly referred to as the Freedom of Information Act, or of any other law, the Commission shall not be compelled to disclose records obtained from a foreign securities authority if the foreign securities authority

has in good faith represented to the Commission that public disclosure of such records would be contrary to the laws applicable to that foreign securities authority.

"(e) Nothing in this section shall—

"(1) alter the Commission's responsibilities under the Right to Financial Privacy Act (12 U.S.C. 3401 et seq.), as limited by Section 21(h) of the Securities Exchange Act (15 U.S.C. 78u(h)), with respect to transfers of records covered by such statutes, or

"(2) authorize the Commission to withhold information from the Congress or prevent the Commission from complying with an order of a court of the United States in an action commenced by the United States or the Commission.".

SEC. 3. SANCTIONS AGAINST BROKER OR DEALER, ASSOCIATED PERSONS, OR PERSONS SEEKING ASSOCIATION.

(a) AUTHORITY OF THE COMMISSION TO SANCTION BROKERS AND DEALERS FOR FOREIGN VIOLATIONS.—Section 15(b) (15 U.S.C. 78o(b)) of the Securities Exchange Act of 1934 is amended—

(1) in paragraph (4)(B), by inserting after "misdemeanor" the following: "or has been convicted within ten years of a substantially equivalent crime by a foreign court of competent jurisdiction";

(2) in paragraph (4)(B)(i), by inserting after "burglary," the following: "any substantially equivalent activity however denominated by the laws of the relevant foreign government";

(3) in paragraph (4)(B)(ii)—

(A) by inserting after "transfer agent," the following: "foreign person performing a function substantially equivalent to any of the above,";

(B) by inserting after "(7 U.S.C. 1 et seq.)" the following: "or any substantially equivalent foreign statute or regulation";

(4) in paragraph (4)(B)(iii), by inserting after "securities," the following: "or substantially equivalent activity however denominated by the laws of the relevant foreign government,";

(5) in paragraph (4)(B)(iv), by inserting after "United States Code" the following: ", or a violation of a substantially equivalent foreign statute.";

(6) in paragraph (4)(C)—

(A) by inserting after "transfer agent," "foreign person performing a function substantially equivalent to any of the above,";

(B) by inserting after "Commodity Exchange Act" each time it appears, "or any substantially equivalent foreign statute or regulation"; and

(C) by inserting after "insurance company," "foreign entity substantially equivalent to any of the above,"; and

(7) by inserting after subparagraph (F) of paragraph 4 the following:

"(G) has been found by a foreign financial regulatory authority to have—

"(i) made or caused to be made in any application for registration or report required to be filed with a foreign financial regulatory authority, or in any proceeding before a foreign financial regulatory authority with respect to registration, any statement that was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any application or report to the foreign financial regulatory authority any material fact that is required to be stated therein;

"(ii) violated any foreign statute or regulation regarding transactions in securities, or contracts of sale of a commodity for future delivery, traded on or subject to the rules of a contract market or any board of trade;

"(iii) aided, abetted, counseled, commanded, induced, or procured the violation by any person of any provision of any statutory provisions enacted by a foreign government, or rules or regulations thereunder, empowering a foreign financial regulatory authority regarding transactions in securities, or contracts of sale of a commodity for future delivery, traded on or subject to the rules of a contract market or any board of trade, or has been found, by a foreign financial regulatory authority, to have failed reasonably to supervise, with a view to preventing violations of such statutory provisions, rules, and regulations, another person who commits such a violation, if such other person is subject to his supervision.".

(b) EXTENSION OF DEFINITION OF STATUTORY DISQUALIFICATION TO INCLUDE FOREIGN VIOLATIONS.—Section 3(a)(39) of such Act (15 U.S.C. 78c(a)(39)) is amended—

(1) in subparagraphs (A)—

(A) by inserting after "self-regulatory organization," the following: "foreign equivalent of a self-regulatory organization, foreign or international securities exchange,"; and

(B) by inserting after both "(7 U.S.C. 7)," and "(7 U.S.C. 21),", the following: "or any sub-

stantially equivalent foreign statute or regulation,";

(C) by inserting after "contract market", the following: "or foreign equivalent";

(2) in subparagraph (B)—

(A) by striking "Commission or other appropriate regulatory agency" and inserting "Commission, other appropriate regulatory agency, or foreign financial regulatory authority";

(B) by inserting after "government securities dealer," the first place it appears, the following: "or limiting his activities as a foreign person performing a function substantially equivalent to any of the above,";

(C) by inserting after "government securities dealer," the second place it appears, the following: ", or foreign person performing a function substantially equivalent to any of the above,";

(D) by striking the semicolon and inserting the following: ", or is subject to an order by a foreign financial regulatory authority denying, suspending, or revoking the person's authority to engage in transactions in contracts of sale of a commodity for future delivery or other instruments traded on or subject to the rules of a con-

tract market, board of trade, or foreign equivalent thereof;".

(3) by redesignating subparagraphs (D) and (E) as subparagraphs (E) and (F), respectively; –

(4) by inserting after subparagraph (C) the following:

"(D) by his conduct while associated with any broker, dealer, municipal securities dealer, government securities broker, government securities dealer, or any other entity engaged in transactions in securities, or while associated with an entity engaged in transactions in contracts of sale of a commodity for future delivery or other instruments traded on or subject to the rules of a contract market, board of trade, or foreign equivalent thereof, has been found to be a cause of any effective suspension, expulsion, or order by a foreign or international securities exchange or foreign financial regulatory authority empowered by a foreign government to administer or enforce its laws relating to financial transactions as described in subparagraph (A) or (B) of this paragraph;";

(5) in subparagraph (E) (as redesignated by paragraph (3) of this subsection) by striking "(A), (B), or (C)" and inserting "(A), (B), (C), or (D)".

(6) in subparagraph F (as redesignated) by striking "(D) or (E)" and inserting in lieu thereof "(D), (E), or (G)" and by inserting after "such paragraph (4)" the first place it appears the following: "or any other felony".

(c) CONFORMING AMENDMENTS.—The Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.) is amended—

(1) in sections 15(b)(6), 15B(c)(2), 15B(c)(4), 15C(1)(A), 15C(c)(1)(c), 17A(c)(3)(A), and 17A(c)(3)(C), by striking "(A), (D), or (E)" and inserting "(A), (D), (E), or (G)"; and

(2) in section 15C(f)(2), by striking "or the rules or regulations under any such other provision" and inserting "the rules or regulations under any such other provision, or investigations pursuant to section 21(a)(2) of this title to assist a foreign securities authority.".

SEC. 4. DEFINITION OF FOREIGN FINANCIAL REGULATORY AUTHORITY.

Section 3(a) of the Securities Exchange Act of 1934 (15 U.S.C. 78c(a)) is further amended by adding at the end thereof the following new paragraph:

"(51) The term 'foreign financial regulatory authority' means any (A) foreign securities authority, (B) other governmental body or foreign equivalent of a self-regulatory organization empowered by a foreign

government to administer or enforce its laws relating to the regulation of fiduciaries, trusts, commercial lending, insurance, trading in contracts of sale of a commodity for future delivery, or other instruments traded on or subject to the rules of a contract market, board of trade, or foreign equivalent, or other financial activities, or (C) membership organization a function of which is to regulate participation of its members in activities listed above.".

SEC. 5. SANCTIONS AGAINST INVESTMENT ADVISERS OR PERSONS ASSOCIATED OR SEEKING ASSOCIATION WITH A REGISTERED INVESTMENT ADVISER OR INVESTMENT COMPANY.

(a) INVESTMENT COMPANY ACT OF 1940.—Section 9(b) of the Investment Company Act of 1940 (15 U.S.C. 80a–9(b)) is amended—

(1) by striking "or" at the end of paragraph (2);

(2) by striking the period at the end of paragraph (3) and inserting a semicolon; and by inserting after paragraph (3) the following:

"(4) has been found by a foreign financial regulatory authority to have—

"(A) made or caused to be made in any application for registration or report required to be filed with a foreign securities authority, or in any

proceeding before a foreign securities authority with respect to registration, any statement that was at the time and in light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any application or report to a foreign securities authority any material fact that is required to be stated therein;

"(B) violated any foreign statute or regulation regarding transactions in securities or contracts of sale of a commodity for future delivery traded on or subject to the rules of a contract market or any board of trade;

"(C) aided, abetted, counseled, commanded, induced, or procured the violation by any other person of any foreign statute or regulation regarding transactions in securities or contracts of sale of a commodity for future delivery traded on or subject to the rules of a contract market or any board of trade;

"(5) within ten years has been convicted by a foreign court of competent jurisdiction of a crime, however, denominated by the laws of the relevant foreign government, that is substantially equivalent to an offense set forth in paragraph (1) of subsection (a); or

"(6) by reason of any misconduct, is temporarily or permanently enjoined by any foreign court of competent jurisdiction from acting in any of the capacities, set forth in paragraph (2) of subsection (a), or a substantially equivalent foreign capacity, or from engaging in or continuing any conduct or practice in connection with any such activity or in connection with the purchase or sale of any security.".

(b) INVESTMENT ADVISERS ACT OF 1940.—Section 203(e) of the Investment Advisers Act of 1940 (15 U.S.C. 80b–3(e)) is amended—

(1) in paragraph (2) by inserting after "misdemeanor" the following: "or has been convicted within ten years of a substantially equivalent crime by a foreign court of competent jurisdiction";

(2) in paragraph (2)(A), by inserting after "burglary," the following: "any substantially equivalent activity however denominated by the laws of the relevant foreign government,";

(3) in paragraphs (2)(B) and (3)—

(A) by inserting after "transfer agent" the following: "foreign person performing a function substantially equivalent to any of the above,"; and

(B) after "Commodity Exchange Act" each place it appears, the following: "or any substantially equivalent statute or regulation";

(4) in paragraph (2)(C), by inserting after "securities" the following: "or substantially equivalent activity however denominated by the laws of the relevant foreign government";

(5) in paragraph (2)(D) by inserting after "United States Code" the following: ", or a violation of a substantially equivalent foreign statute";

(6) in paragraph (3)—

(A) by inserting after "court of competent jurisdiction" the following: ", including any foreign court of competent jurisdiction,"; and

(B) by inserting after "insurance company," the following: "foreign entity substantially equivalent to any of the above,";

(7) in paragraph (5), by inserting after "this title," the following: "the Commodity Exchange Act,";

(8) by inserting after paragraph (6) the following new paragraph:

"(7) has been found by a foreign financial regulatory authority to have—

"(A) made or caused to be made in any application for registration or report required to be

filed with a foreign securities authority, or in any proceeding before a foreign securities authority with respect to registration, any statement that was at the time and in light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any application or report to a foreign securities authority any material fact that is required to be stated therein;

"(B) violated any foreign statute or regulation regarding transactions in securities or contracts of sale of a commodity for future delivery traded on or subject to the rules of a contract market or any board of trade;

"(C) aided, abetted, counseled, commanded, induced, or procured the violation by any other person of any foreign statute or regulation regarding transactions in securities or contracts of sale of a commodity for future delivery traded on or subject to the rules of a contract market or any board of trade, or has been found, by the foreign financial regulatory authority, to have failed reasonably to supervise, with a view to preventing violations of statutory provisions, and rules and regulations promulgated thereunder, another

person who commits such a violation, if such other person is subject to his supervision.".

(c) CONFORMING AMENDMENT.—Section 203(f) of the Investment Advisers Act of 1940 (15 U.S.C. 80b–3(f)) is amended by striking "paragraph (1), (4), or (5)" and inserting "paragraph (1), (4), (5), or (7)".

SEC. 6. DEFINITION OF FOREIGN SECURITIES AUTHORITY AND FOREIGN FINANCIAL REGULATORY AUTHORITY.

(a) INVESTMENT COMPANY ACT OF 1940.—Section 2(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80a–2(a)) is amended by inserting after paragraph (48) the following:

"(49) 'Foreign securities authority' means any foreign government or any governmental body or regulatory organization empowered by a foreign government to administer or enforce its laws as they relate to securities matters.

"(50) 'Foreign financial regulatory authority' means any (A) foreign securities authority, (B) other governmental body or foreign equivalent of a self-regulatory organization empowered by a foreign government to administer or enforce its laws relating to the regulation of fiduciaries, trusts, commercial lending, insurance, trading in contracts of sale of a commodity for

future delivery, or other instruments traded on or subject to the rules of a contract market, board of trade or foreign equivalent, or other financial activities, or (C) membership organization a function of which is to regulate the participation of its members in activities listed above.".

(b) INVESTMENT ADVISERS ACT OF 1940.—Section 202(a) of the Investment Advisers Act of 1940 (15 U.S.C. 80b–2(a)) is amended by inserting after paragraph (22) the following:

"(23) 'Foreign securities authority' means any foreign government, or any governmental body or regulatory organization empowered by a foreign government to administer or enforce its laws as they relate to securities matters.

"(24) 'Foreign financial regulatory authority' means any (A) foreign securities authority, (B) other governmental body or foreign equivalent of a self-regulatory organization empowered by a foreign government to administer or enforce its laws relating to the regulation of fiduciaries, trusts, commercial lending, insurance, trading in contracts of sale of a commodity for future delivery, or other instruments traded on or subject to the rules of a contract market, board of trade or foreign equivalent, or other financial activities, or (C)

membership organization a function of which is to regulate participation of its members in activities listed above.".

SEC. 7. REIMBURSEMENT OF EXPENSES INCURRED IN AN INVESTIGATION UNDERTAKEN AT THE REQUEST OF A FOREIGN SECURITIES AUTHORITY.

Section 4 of the Securities Exchange Act of 1934 (15 U.S.C. 78d(c)) is amended by adding at the end thereof the following new subsection:

"(f) Notwithstanding any other provision of law, the Commission may accept payment and reimbursement, in cash or in kind, from a foreign securities authority, or made on behalf of such authority, for necessary expenses incurred by the Commission, its members, and employees in carrying out any investigation pursuant to section 21(a)(2) of this title or in providing any other assistance to a foreign securities authority. Any payment or reimbursement accepted shall be considered a reimbursement to the appropriated funds of the Commission.".

O

II

101ST CONGRESS
1ST SESSION

S. 647

To amend the Federal securities laws in order to provide additional enforcement remedies for violations of those laws.

IN THE SENATE OF THE UNITED STATES

MARCH 17 (legislative day, JANUARY 3), 1989

Mr. DODD (for himself and Mr. HEINZ) (by request) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

---

A BILL

To amend the Federal securities laws in order to provide additional enforcement remedies for violations of those laws.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE; TABLE OF CONTENTS; EFFECTIVE DATE.

(a) SHORT TITLE.—This Act may be cited as the "Securities Law Enforcement Remedies Act of 1989".

(b) TABLE OF CONTENTS.—

TITLE I—AMENDMENTS TO THE SECURITIES ACT OF 1933

Sec. 101. Authority of a court to prohibit persons from serving as officers and directors.

Sec. 102. Monetary penalties in civil proceedings.

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TITLE II—AMENDMENTS TO THE SECURITIES EXCHANGE ACT OF 1934

Sec. 201. Amendments to section 15(c)(4).
Sec. 202. Enforcement of title.
Sec. 203. Monetary penalties in administrative proceedings.
Sec. 204. Conforming amendment to section 15B.

TITLE III—AMENDMENTS TO THE INVESTMENT COMPANY ACT OF 1940

Sec. 301. Monetary penalties in administrative proceedings.
Sec. 302. Enforcement of title.

TITLE IV—AMENDMENTS TO THE INVESTMENT ADVISERS ACT OF 1940

Sec. 401. Monetary penalties in administrative proceedings.
Sec. 402. Enforcement of title.
Sec. 403. Conforming amendment to section 214.

(c) EFFECTIVE DATE.—The amendments made by this Act shall not apply to any conduct occurring before the date of the enactment of this Act.

TITLE I—AMENDMENTS TO THE SECURITIES ACT OF 1933

SEC. 101. AUTHORITY OF A COURT TO PROHIBIT PERSONS FROM SERVING AS OFFICERS AND DIRECTORS.

Section 20(b) of the Securities Act of 1933 (15 U.S.C. 77t(b)) is amended by inserting after the first sentence thereof the following: "In any proceeding under this subsection, the court may prohibit, conditionally or unconditionally, either permanently or for such period of time as it shall determine, any person found to have violated any provision of this title or any rule or regulation thereunder from acting as an officer or director of any issuer that has a class of securities registered pursuant to section 12 of the Securities Exchange Act

of 1934 (15 U.S.C. 78l) or that is required to file reports pursuant to subsection (d) of section 15 of such Act (15 U.S.C. 78o)."

SEC. 102. MONETARY PENALTIES IN CIVIL PROCEEDINGS.

Section 20 of the Securities Act of 1933 (15 U.S.C. 77t) is amended—

(1) by redesignating subsection (c) as subsection (d); and

(2) by inserting after subsection (b) the following:

"(c)(1) Whenever it shall appear to the Commission that any person has violated any provision of this title or the rules or regulations thereunder, the Commission may bring an action seeking to impose, and the court shall have jurisdiction to impose, based upon a finding of a violation, a civil penalty against such person. The amount of the penalty shall be determined by the court in light of the facts and circumstances. For each violation, the amount of the penalty shall not exceed the greater of (1) $100,000 for a natural person or $500,000 for any other person, or (2) the gross amount of pecuniary gain to such defendant as a result of the violation. The penalty shall be payable into the Treasury of the United States.

"(2) If a person upon whom a penalty is assessed under this subsection fails to pay such penalty within the time prescribed in the court's order, the Commission shall refer the

matter to the Attorney General who shall recover such penalty by action in the appropriate United States district court.

"(3) The actions authorized by this subsection may be brought in addition to any other actions that the Commission or the Attorney General is entitled to bring. For purposes of section 22 of this title, actions under this subsection shall be actions to enforce a liability or a duty created by this title.".

TITLE II—AMENDMENTS TO THE SECURITIES EXCHANGE ACT OF 1934

SEC. 201. AMENDMENTS TO SECTION 15(C)(4).

Section 15(c)(4) of the Securities Act of 1934 (15 U.S.C. 78o(c)(4)) is amended—

(1) by striking ", or" the first time it appears; and

(2) by inserting after "15" the following: ", or subsection (a) of section 16"; and

(3) by adding at the end thereof the following: "In such an order, the Commission may also prohibit, conditionally or unconditionally, either permanently or for such period of time as it shall determine, any person found to have failed to comply or to have been a cause of the failure to comply from acting as an officer or director of any issuer that has a class of securities registered pursuant to section 12 of this title or that is required to file reports pursuant to subsection (d) of sec-

tion 15 of this title, if the Commission finds that such prohibition is in the public interest.".

SEC. 202. ENFORCEMENT OF TITLE.

Section 21(d) of the Securities Exchange Act of 1934 (15 U.S.C. 78u(d)) is amended to read as follows:

"(d)(1) Whenever it shall appear to the Commission that any person is engaged or is about to engage in acts or practices constituting a violation of any provision of this title, the rules or regulations thereunder, the rules of a national securities exchange or registered securities association of which such person is a member or a person associated with such member, the rules of a registered clearing agency in which such person is a participant, or the rules of the Municipal Securities Rulemaking Board, the Commission may in its discretion bring an action in the proper district court of the United States, the United States District Court for the District of Columbia, or the United Sates courts of any territory or other place subject to the jurisdiction of the United States, to enjoin such acts or practices, and upon a proper showing a permanent or temporary injunction or restraining order shall be granted without bond. In any proceeding under this paragraph, the court may prohibit, conditionally or unconditionally, either permanently or for such period of time as it shall determine, any person found to have violated any provision of this title or the rules and regulations thereunder from acting

as an officer or director of any issuer that has a class of securities registered pursuant to section 12 of this title or that is required to file reports pursuant to subsection (d) of section 15 of this title. The Commission may transmit such evidence of acts or practices as may constitute a violation of any provision of this title or the rules or regulations thereunder to the Attorney General, who may, in his discretion, institute the necessary criminal proceedings under this title.

"(2) Whenever it shall appear to the Commission that any person has violated any provision of this title or the rules or regulations thereunder, other than by committing a violation subject to a penalty pursuant to section 21A, the Commission may bring an action seeking to impose, and the court shall have jurisdiction to impose, based upon a finding of a violation, a civil penalty against such person. The amount of the penalty shall be determined by the court in light of the facts and circumstances. For each violation, the amount of the penalty shall not exceed the greater of (A) $100,000 for a natural person or $500,000 for any other person, or (B) the gross amount of pecuniary gain to such defendant as a result of the violation. The penalty shall be payable into the Treasury of the United States. If a person upon whom such a penalty is assessed shall fail to pay such penalty within the time prescribed in the court's order, the Commission shall refer the matter to the Attorney General who shall recover

such penalty by action in the appropriate United States district court. The action authorized by this paragraph may be brought in addition to any other action that the Commission or the Attorney General is entitled to bring. For purposes of section 27 of this title, actions under this paragraph shall be actions to enforce a liability or a duty created by this title.".

SEC. 203. MONETARY PENALTIES IN ADMINISTRATIVE PROCEEDINGS.

The Securities Exchange Act of 1934 is amended by inserting after section 21A (15 U.S.C. 78u–1) the following:

"MONETARY PENALTIES IN ADMINISTRATIVE PROCEEDINGS

"SEC. 21B. (a) In any proceeding instituted pursuant to section 15(c)(4) of this title against any person, the Commission may assess a civil penalty if it finds, on the record after notice and opportunity for hearing, that such person—

"(1) failed to comply with any provision of sections 12, 13, 14, subsection (d) of section 15, or subsection (a) of section 16 of this title, or any rule or regulation thereunder, in any material respect, or

"(2) was a cause of any other person's failure to so comply due to an act or omission the person knew or should have known would contribute to the failure to comply,

and that such penalty is in the public interest. The maximum amount of the penalty for each failure to comply or for each

such failure to comply for which a person was a cause, shall be $100,000 for a natural person or $500,000 for any other person.

"(b) In any proceeding instituted pursuant to section 15(b)(4), 15(b)(6), 15B, 15C, or 17A of this title against any person, the Commission or the appropriate regulatory agency may assess a civil penalty if it finds, on the record after notice and opportunity for hearing, that such person—

"(1) has willfully violated any provision of the Securities Act of 1933 (15 U.S.C. 77a et seq.), the Investment Company Act of 1940 (15 U.S.C. 80a–1 et seq.), the Investment Advisers Act of 1940 (15 U.S.C. 80b–1 et seq.), or this title, or the rules or regulations thereunder, or the rules of the Municipal Securities Rulemaking Board;

"(2) has willfully aided, abetted, counseled, commanded, induced, or procured such a violation by any other person;

"(3) has willfully made or caused to be made in any application for registration or report required to be filed with the Commission or with any other appropriate regulatory agency under this title, or in any proceeding before the Commission with respect to registration, any statement which was at the time in the light of the circumstances under which it was made

false or misleading with respect to any material fact, or has omitted to state in any such application or report any material fact which is required to be stated therein; or

"(4) has failed reasonably to supervise within the meaning of section 15(b)(4)(E) of this title, with a view to preventing violations of the provisions of such statutes, rules and regulations, another person who commits such a violation, if such other person is subject to his supervision;

and that such penalty is in the public interest. The maximum amount of penalty for each such act or omission shall be $100,000 for a natural person or $500,000 for any other person.

"(c) In consideration under this section whether a penalty is in the public interest, the Commission or the appropriate regulatory agency may consider—

"(1) whether the act or omission for which such penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement;

"(2) the harm to other persons resulting either directly or indirectly from such act or omission;

"(3) the extent to which any person was unjustly enriched, taking into account any restitution made to persons injured by such behavior;

"(4) whether such person previously has been found by the Commission, other appropriate regulatory agency, or self-regulatory organization to have violated the Federal securities laws, State securities laws, or the rules of a self-regulatory organization, or has been enjoined by a court of competent jurisdiction from violations of such laws or rules;

"(5) the need to deter such person and other persons from committing such acts or omissions; and

"(6) such other matters as justice may require.

"(d) In any proceeding in which the Commission or the appropriate regulatory agency may assess a penalty under this section, a respondent may present evidence of the respondent's ability to pay such penalty. The Commission or the appropriate regulatory agency may, in its discretion, consider such evidence in determining whether such penalty is in the public interest. Such evidence may relate to the extent of such person's ability to continue in business, and the collectability of a penalty, taking into account any other claims of the United States or third parties upon such person's assets and the amount of such person's assets.".

SEC. 204. CONFORMING AMENDMENTS TO SECTION 15B.

Section 15B(c)(6)(A) of the Securities Exchange Act of 1934 (15 U.S.C. 78o–4(c)(6)(A)) is amended—

(1) by striking "and" after "identity of such municipal securities dealer or person associated with such municipal securities dealer" and inserting a comma;

(2) by inserting a comma after "proposed action"; and

(3) by inserting before "(ii)" the following: "whether the Commission is seeking a monetary penalty against such municipal securities dealer or such associated person pursuant to section 21B of this title; and".

TITLE III—AMENDMENTS TO THE INVESTMENT COMPANY ACT OF 1940

SEC. 301. MONETARY PENALTIES IN ADMINISTRATIVE PROCEEDINGS.

Section 9 of the Investment Company Act of 1940 (15 U.S.C. 80a–9) is amended—

(1) by redesignating subsection (d) as subsection (e);

(2) by inserting after subsection (c) the following: "(d)(1) In any proceeding instituted pursuant to subsection (b) against any person, the Commission may assess a

civil penalty if it finds, on the record after notice and opportunity for hearing, that such person—

"(A) has willfully violated any provision of the Securities Act of 1933 (15 U.S.C. 77a et seq.), the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.), the Investment Advisers Act of 1940 (15 U.S.C. 80b–1 et seq.), or this title, or the rules or regulations thereunder;

"(B) has willfully aided, abetted, counseled, commanded, induced, or procured such a violation by any other person; or

"(C) has willfully made or caused to be made in any registration statement, application, or report required to be filled with the Commission under this title, any statement which was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any such registration statement, application, or report any material fact which was required to be stated therein;

and that such penalty is in the public interest. The maximum amount of the penalty for each such act or omission shall be $100,000 for a natural person or $500,000 for any other person.

"(2) In considering under this section whether a penalty is in the public interest, the Commission may consider—

"(A) whether the act or omission for which such penalty is assessed involved fraud, deceit, manipulation, of deliberate or reckless disregard of a regulatory requirement;

"(B) the harm to other persons resulting either directly or indirectly from such act or omission;

"(C) the extent to which any person was unjustly enriched, taking into account any restitution made to persons injured by such behavior;

"(D) whether such a person previously has been found by the Commission, other appropriate regulatory agency, of self-regulatory organization to have violated the Federal securities laws, State securities laws, or the rules of a self-regulatory organization, or has been enjoined by a court of competent jurisdiction from violations of such laws or rules;

"(E) the need to deter such person and other persons from committing such acts or omissions; and

"(F) such other matters as justice may require.

"(3) In any other proceeding in which the Commission may assess a penalty under this section, a respondent may present evidence of the respondent's ability to pay such penalty. The Commission may, in its discretion, consider such

evidence in determining whether such penalty is in the public interest. Such evidence may relate to the extent of such person's ability to continue in business, and the collectability of a penalty, taking into account any other claims of the United States or third parties upon such person's assets and the amount of such person's assets."; and

(3) in redesignated subsectior (e), by striking the following: "subsections (a) through (c) of".

SEC. 302. ENFORCEMENT OF TITLE.

Section 42 of the Investment Company Act of 1940 (15 U.S.C. 80a–41) is amended by—

(1) inserting after the first sentence of subsection (d) the following: "In any proceeding under this subsection the court may prohibit, conditionally or unconditionally, either permanently or for such period of time as it shall determine, any person found to have violated any provision of this title or any rule, regulation, or order hereunder from acting as an officer or director of any issuer that has a class of securities registered pursuant to section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l) or that is required to file reports pursuant to subsection (d) of section 15 of such Act (15 U.S.C. 78o(d))."; and

(2) adding at the end the following:

"(e) Whenever it shall appear to the Commission that any person has violated any provision of this title or the rules or regulations thereunder, the Commission may bring an action seeking to impose, and the court shall have jurisdiction to impose, based upon a finding of a violation, a civil penalty against such person. The amount of the penalty shall be determined by the court in light of the facts and circumstances. For each violation, the amount of the penalty shall not exceed the greater of (1) $100,000 for a natural person or $500,000 for any other person, or (2) the gross amount of pecuniary gain to such defendant as a result of the violation. The penalty shall be payable into the Treasury of the United States. If a person upon whom such a penalty is assessed shall fail to pay such penalty within the time prescribed in the court's order, the Commission shall refer the matter to the Attorney General who shall recover such penalty by action in the appropriate United States district court. The actions authorized by this subsection may be brought in addition to any other actions that the Commission or the Attorney General is entitled to bring. For purposes of section 44 of this title, actions under this subsection shall be actions to enforce a liability or a duty created by this title.".

TITLE IV—AMENDMENTS TO THE INVESTMENT ADVISERS ACT OF 1940

SEC. 401. MONETARY PENALTIES IN ADMINISTRATIVE PROCEEDINGS.

Section 203 of the Investment Advisers Act of 1940 (15 U.S.C. 80b–3) is amended by adding at the end the following:

"(i)(1) In any proceeding instituted pursuant to subsection (e) or (f) against any person, the Commission may assess a civil penalty if it finds, upon the record after notice and opportunity for hearing, that such person—

"(A) has willfully violated any provision of the Securities Act of 1933 (15 U.S.C. 77a et seq.), the Securities Exchange Act of 1934 (15 U.S.C. 78a et seq.), the Investment Company Act of 1940 (15 U.S.C. 80a–1 et seq.), or this title, or the rules and regulations thereunder;

"(B) has willfully aided, abetted, counseled, commanded, induced, or procured such a violation by any other person;

"(C) has willfully made or caused to be made in any application for registration or report required to be filed with the Commission under this title, or in any proceeding before the Commission with respect to reg-

istration, any statement which was at the time and in the light of the circumstances under which it was made false or misleading with respect to any material fact, or has omitted to state in any such registration statement, application, or report any material fact which was required to be stated therein; or

"(D) has failed reasonably to supervise, within the meaning of section 203(e)(5) of this title, with a view to preventing violations of the provisions of this title and such rules and regulations, another person who commits such a violation, if such other person is subject to his supervision;

and that such penalty is in the public interest. The maximum amount of the penalty for each such act or omission shall be $100,000 for a natural person or $500,000 for any other person.

"(2) In considering under this section whether a penalty is in the public interest, the Commission may consider—

"(A) whether the act or omission for which such penalty is assessed involved fraud, deceit, manipulation, or deliberate or reckless disregard of a regulatory requirement;

"(B) the harm to other persons resulting either directly or indirectly from such act or omission;

"(C) the extent to which any person was unjustly enriched, taking into account any restitution made to persons injured by such behavior;

"(D) whether such a person previously had been found by the Commission, other appropriate regulatory agency, or self-regulatory organization to have violated the Federal securities laws, State securities laws, or the rules of a self-regulatory organization, or has been enjoined by a court of competent jurisdiction from violations of such laws or rules;

"(E) the need to deter such person and other persons from committing such acts or omissions; and

"(F) such other matters as justice may require.

"(3) In any proceeding in which the Commission may assess a penalty under this section, a respondent may present evidence of the respondent's ability to pay such penalty. The Commission may, in its discretion, consider such evidence in determining whether such penalty is in the public interest. Such evidence may relate to the extent of such person's ability to continue in business, and the collectability of a penalty, taking into account any other claims of the United States or third parties upon such person's assets and the amount of such person's assets.".

SEC. 402. ENFORCEMENT OF TITLE.

Section 209 of the Investment Advisers Act of 1940 (15 U.S.C. 80b–9) is amended—

(1) by inserting after the first sentence of subsection (d) the following: "In any proceeding under this paragraph, the court may prohibit, conditionally or unconditionally, either permanently or for such period of time as it shall determine, any person found to have violated any provision of this title, or of any rule, regulation, or order hereunder or has aided, abetted, counseled, commanded, induced, or procured such a violation, from acting as an officer or director of any issuer that has a class of securities registered pursuant to section 12 of the Securities Exchange Act of 1934 (15 U.S.C. 78l) or that is required to file reports pursuant to subsection (d) of section 15 of such Act (15 U.S.C. 78o)."; and

(2) by adding at the end the following:

"(e) Whenever it shall appear to the Commission that any person has violated any provision of this title or the rules or regulations thereunder, the Commission may bring an action seeking to impose, and the court shall have jurisdiction to impose, based upon a finding of a violation, a civil penalty against such person. The amount of the penalty shall be determined by the court in light of the facts and circumstances. For each violation, the amount of the penalty shall not

exceed the greater of (1) $100,000 for a natural person or $500,000 for any other person, or (2) the gross amount of pecuniary gain to such defendant as a result of the violation. The penalty shall be payable into the Treasury of the United States. If a person upon whom such a penalty is assessed shall fail to pay such penalty within the time prescribed in the court's order, the Commission shall refer the matter to the Attorney General who shall recover such penalty by action in the appropriate United States district court. The actions authorized by this subsection may be brought in addition to any other actions that the Commission or the Attorney General is entitled to bring. For purposes of section 214 of this title, actions under this subsection shall be actions to enforce a liability or a duty created by this title.".

SEC. 403. CONFORMING AMENDMENT TO SECTION 214.

Section 214 of the Investment Advisers Act of 1940 (15 U.S.C. 80b–14) is amended—

(1) by inserting after "all suits in equity", the following: "and actions at law brought to enforce any liability or duty created by, or"; and

(2) by inserting after "Any suit or action", the following: "to enforce any liability or duty created by, or".

II

101ST CONGRESS
1ST SESSION

S. 648

To amend the Securities Exchange Act of 1934.

IN THE SENATE OF THE UNITED STATES

MARCH 17 (legislative day, JANUARY 3), 1989

Mr. DODD (for himself and Mr. HEINZ) (by request) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing and Urban Affairs

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A BILL

To amend the Securities Exchange Act of 1934.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act may be cited as the "Market Reform Act of 1989".

SEC. 2. EMERGENCY AUTHORITY; TRADING HALTS.

Section 12 of the Securities Exchange Act of 1934 (12 U.S.C. 78l) is amended by adding at the end the following:

"(m)(1) The Commission, in an emergency, may by order summarily take such action to alter, supplement, suspend, or impose requirements or restrictions with respect to

any matter or action subject to regulation by the Commission or a self-regulatory organization under this title, as the Commission determines is necessary in the public interest and for the protection of investors to maintain or restore fair and orderly securities markets (other than markets in exempted securities) or to ensure prompt and accurate clearance and settlement of transactions in securities (other than exempted securities). An order of the Commission under this paragraph shall continue in effect for the period specified by the Commission, and may be extended, except that in no event shall the Commission's action continue in effect for more than 10 business days, including extensions. In exercising its authority under this paragraph, the Commission shall not be required to comply with the provisions of section 553 of title 5, United States Code, or with the provisions of section 19(c) of this title.

"(2) In the exercise of its emergency powers pursuant to paragraph (1) of this subsection, the Commission is authorized to suspend summarily all trading in any or all securities (other than exempted securities) on any national securities exchange or otherwise for such period specified by the Commission, or until such time as the Commission authorizes the resumption of trading, but not for more than 24 hours. The Commission, with the approval of the President, may deter-

mine to extend such suspension for not more than two additional 24-hour periods.

"(3) The President may direct that emergency action taken by the Commission under paragraph (1) or (2) of this subsection shall not continue in effect.

"(4) For purpose of this subsection, the term 'emergency' means a major market disturbance characterized by, or constituting—

"(A) a substantial threat of sudden and excessive fluctuations of securities prices generally that threaten fair and orderly markets, or

"(B) a substantial disruption of the safe or efficient operation of the national system for clearance and settlement of securities.

"(5) No member of a national securities exchange, broker, or dealer shall make use of the mails or any means or instrumentality of interstate commerce to effect any transaction in, or to induce the purchase or sale of, any security in contravention of an order entered by the Commission under this subsection unless such order has been stayed, modified, or set aside as provided in paragraph (6) of this subsection.

"(6) Any action taken by the Commission pursuant to this subsection shall be subject to review only as provided in section 25(a) of this title. Review shall be based on an examination of all the information before the Commission at the

time such action was taken. The reviewing court shall not enter a stay, writ of mandamus, or similar relief unless the court finds, after notice and hearing before a panel of the court, that the Commission's action is arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law.".

SEC. 3. LARGE TRADER REPORTING.

Section 13 of the Securities Exchange Act of 1934 (15 U.S.C. 78m) is amended by adding at the end the following:

"(h)(1) For the purpose of monitoring the impact on the securities markets of securities transactions involving a substantial volume or a large fair market value or exercise value, and related transactions in equity index futures and options on such futures, every person who, for his own account or an account for which he exercises investment discretion, effects—

"(A) transactions for the purchase or sale of any publicly traded securities or options, or

"(B) transactions in contracts of sale (or options on such contracts) for future delivery of a group or index of publicly traded securities (or any interest therein or based on the value thereof) that are related to transactions in publicly traded securities or options,

by use of any means or instrumentality of interstate commerce or of the mails, or of any facility of a national securi-

ties exchange or board of trade, during any 24-hour period in an amount equal to or in excess of such amount as shall be fixed from time to time by the Commission, shall file reports regarding such transactions with the Commission, or any self-regulatory organization as the Commission shall designate by rule, regulation, or order to receive such reports. Reports required under this subsection shall be filed at such times, and include such information with respect to any transaction or series of transactions subject to this subsection, as the Commission, by rule, regulation, or order may prescribe.

"(2) For purposes of this subsection—

"(A) the term 'publicly traded securities or options' means any equity securities, including options on individual equity securities, and options on a group or index of such securities, listed, or admitted to unlisted trading privileges, on a national securities exchange, or quoted in an automated interdealer quotation system;

"(B) two or more persons acting as a partnership, limited partnership, syndicate, or other group, for the purpose of effecting transactions described in paragraph (1) of this subsection, shall be deemed a 'person'.

"(3) The Commission may prescribe rules governing the manner in which transactions and accounts shall be aggregated for the purpose of paragraph (1) of this subsection.

"(4) Notwithstanding the provisions of section 552 of title 5, United States Code, or of any other law, the Commission shall not be compelled to disclose any information required to be reported under this subsection. Nothing in this subsection shall prevent the Commission from complying with a request for information from a duly authorized committee or subcommittee of the Congress or complying with an order of a court of the United States in an action commenced by the United States or the Commission.

"(5) The Commission, by rule, regulation, or order, may exempt any person or classes of persons or any transaction or classes of transactions, either conditionally or upon specified terms and conditions or for stated periods, from the operation of this subsection, and the rules and regulations thereunder.".

SEC. 4. RISK ASSESSMENT FOR HOLDING COMPANY SYSTEMS.

Section 17 of the Securities Exchange Act of 1934 (15 U.S.C. 78q), is amended by adding at the end the following:

"(h)(1) For the purpose of monitoring the financial and operational condition of persons subject to this section, and to provide greater protection for investors, every person who is (A) a registered broker or dealer, or (B) a government securities broker, or government securities dealer, for which the Commission is the appropriate regulatory agency, shall make such reports as the Commission, by rule, regulation, or order prescribes concerning any aspect of the financial or oper-

ational condition of its associated persons, other than a natural person, that the Commission determines is reasonably likely to have a material impact on the financial or operational condition of such registered broker or dealer, government securities broker, government securities dealer, or municipal securities dealer. Reports prescribed by the Commission under this section may include, but shall not be limited to, information concerning assets, liabilities, contingent liabilities, material contracts, loan commitments, trading or investment positions, lines of credit, letters of credit, and financial guarantees.

"(2) No information shall be required of any person subject to paragraph (1) of this subsection regarding any associated person that is—

"(A) a financial institution as defined in section 3(a)(46) of this title;

"(B) a bank holding company, as defined in section 2(a) of the Bank Holding Company Act of 1956 (12 U.S.C. 1841(a));

"(C) a savings and loan holding company, as defined in section 408(a)(1)(D) of the National Housing Act (12 U.S.C. 1730a(a)(1)(D));

"(D) an insurance company, as defined in section 2(13) of the Securities Act of 1933 (15 U.S.C. 77b(13)); or

"(E) a futures commission merchant or introducing broker as defined in section 2(a)(1)(A) of the Commodity Exchange Act (7 U.S.C. 2);

if information substantially similar to that required to be included in reports under paragraph (1) of this subsection is available to a supervisory agency, as defined in section 1101(6) of the Right to Financial Privacy Act of 1978 (12 U.S.C. 3401(6)), a State insurance commission, or similar State agency, or the Commodity Futures Trading Commission.

"(3) The Commission, by rule, regulation, or order, may exempt any person or classes of persons, or any transaction or classes of transactions, either conditionally or upon specified terms and conditions or for stated periods, from the provisions of this subsection, and the rules and regulations thereunder. In granting such exemptions, the Commission shall consider, among other factors, the primary business of any associated person, the nature and extent of domestic or foreign regulation of the associated person's activities and, with respect to the person required to report pursuant to this subsection and its associated persons, on a consolidated basis, the proportion of assets devoted to, and revenues derived from, activities in the United States financial markets.

"(4) Notwithstanding the provisions of section 552 of title 5, United States Code, or of any other law, the Commis-

sion shall not be compelled to disclose any information required to be reported under this subsection. Nothing in this subsection shall prevent the Commission from complying with a request for information from a duly authorized committee or subcommittee of the Congress or complying with an order of a court of the United States in an action commenced by the United States or the Commission.".

SEC. 5. COORDINATED CLEARING.

(a) Section 17A(a)(1) of the Securities Exchange Act of 1934 (15 U.S.C. 78q–1(a)(1)) is amended by adding at the end the following:

"(E)(i) The clearance and settlement systems for transactions in securities, securities options, contracts of sale for future delivery and options thereon, and commodity options are integrally related.

"(ii) The absence of links or coordination among clearing facilities for transactions in securities, securities options, contracts of sale for future delivery and options thereon, and commodity options may impose unnecessary costs and add unnecessary liquidity demands to the nation's financial systems.".

(b) Section 17A(a)(2) of the Securities Exchange Act of 1934 (15 U.S.C. 78q–1(a)(2)) is amended to read as follows:

"(2)(A) The Commission is directed, therefore, having due regard for the public interest, the protec-

tion of investors, the safeguarding of securities and funds, and maintenance of fair competition among brokers and dealers, clearing agencies, and transfer agents, to use its authority under this title—

"(i) to facilitate the establishment of a national system for the prompt and accurate clearance and settlement of transactions in securities (other than exempted securities); and

"(ii) to facilitate the establishment of linked, coordinated, or centralized facilities for clearance and settlement of transactions in securities, securities options, contracts of sale for future delivery and options thereon, and commodity options in accordance with the findings and to carry out the objectives set forth in paragraph (1) of this subsection. The Commission shall use its authority under this title to assure equal regulation under this title of registered clearing agencies and registered transfer agents. In carrying out its responsibilities set forth in clause (ii) of this subparagraph, the Commission shall consult with the Commodity Futures Trading Commission and the Board of Governors of the Federal Reserve System.

"(B) The Securities and Exchange Commission and the Commodity Futures Trading Commission, in

consultation with the Board of Governors of the Federal Reserve System, shall examine progress toward establishing linked, coordinated, or centralized facilities for clearance and settlement of transactions in securities, securities options, contracts of sale for future delivery and options thereon, and commodity options, and shall submit to Congress, not later than 2 years from the date of enactment of this provision, a report detailing and evaluating such progress.".

(c) Section 17A of the Securities Exchange Act of 1934 (15 U.S.C. 78q–1) is amended by adding at the end the following:

"(f) In order to promote prompt and accurate clearance and settlement of securities transactions, notwithstanding any provision of State law, the Commission is authorized to adopt rules concerning the transfer of certificated or uncertificated securities or limited interests (including security interests) therein (but is not authorized to adopt rules concerning the transfer of securities or limited interests (including security interests) therein with respect to government securities issued pursuant to chapter 31 of title 31, United States Code, or securities otherwise processed within a book-entry system operated by the Federal Reserve Banks) if the Commission finds that, in the absence of such rules, the safe and efficient operation of the national system for clearance and settlement

of securities transactions is substantially impeded. In exercising its authority under this subsection, the Commission shall consult with the Secretary of the Treasury.".

(d)(1) Section 5 of the Commodity Exchange Act (7 U.S.C. 22) is amended by adding at the end the following:

"(c)(1) The Congress finds that:

"(A) Commodity clearing organizations play a vital role in the functioning of contract markets and in ensuring the financial integrity of the marketplace in which transactions are executed.

"(B) The clearance and settlement systems for securities, securities options, contracts of sale for future delivery and options thereon, and commodity options are integrally related.

"(C) The absence of links or coordination among clearing facilities for contracts of sale for future delivery and options thereon, commodity options, securities, and securities options may impose unnecessary costs and add unnecessary liquidity demands to the Nation's financial systems.

"(2) The Commission is directed, therefore, having due regard for the public interest and maintenance of fair competition among contract markets, commodities and futures clearing organizations, members thereof, and futures commission merchants, to use its authority under this Act to facili-

tate the establishment of linked, coordinated, or centralized facilities for clearance and settlement of contracts of sale for future delivery and options thereon, commodity options, securities, and securities options, in accordance with the findings set forth in paragraph (1). In carrying out its responsibilities set forth in this paragraph, the Commission shall consult with the Securities and Exchange Commission and the Board of Governors of the Federal Reserve System.".

(3) The Commodity Futures Trading Commission and the Securities and Exchange Commission, in consultation with the Board of Governors of the Federal Reserve System, shall examine progress toward establishing linked, coordinated, or centralized facilities for clearance and settlement of transactions in securities, securities options, contracts of sale for future delivery and options thereon, and commodity options, and shall submit to Congress, not later than 2 years from the date of enactment of this subsection, a report detailing and evaluating such progress.

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II

101ST CONGRESS
1ST SESSION

S. 649

To amend the Securities Exchange Act of 1934 to require that members of exchanges, brokers, dealers, banks, associations, or other entities that exercise fiduciary powers holding securities as nominees provide proxy and other shareholder communications to investment company beneficial security holders; to require these same entities, holding securities as nominees, to provide information statements to investment company and non-investment company beneficial security holders; and to require investment companies to provide information statements to record holders prior to any security holder vote when proxies, consents, or authorizations are not solicited.

IN THE SENATE OF THE UNITED STATES

MARCH 17 (legislative day, JANUARY 3), 1989

Mr. DODD (for himself and Mr. HEINZ) (by request) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing and Urban Affairs

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A BILL

To amend the Securities Exchange Act of 1934 to require that members of exchanges, brokers, dealers, banks, associations, or other entities that exercise fiduciary powers holding securities as nominees provide proxy and other shareholder communications to investment company beneficial security holders; to require these same entities, holding securities as nominees, to provide information statements to investment company and non-investment company beneficial security holders; and to require investment companies to provide information statements to record holders prior to any securi-

ty holder vote when proxies, consents, or authorizations are not solicited.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

This Act shall be cited as the "Shareholder Communications Improvement Act of 1989".

SEC. 2. AMENDMENTS TO 1934 ACT.

(a) SECTION 14(B).—Section 14(b)(1) of the Securities Exchange Act of 1934 (15 U.S.C. 78n(b)(1)) is amended by—

(1) striking "section 12 of this title" and inserting "section 12 of this title or any security issued by an investment company registered under the Investment Company Act of 1940"; and

(2) striking "or authorization" and inserting "authorization, or information statement".

(b) SECTION 14(C).—Section 14(c) of the Securities Exchange Act of 1934 (15 U.S.C. 78n(c)) is amended by striking "title" and inserting "title or a security issued by an investment company registered under the Investment Company Act of 1940".

SEC. 3. EFFECTIVE DATE.

The amendments made by section 2 of this Act shall take effect upon the expiration of 180 days after the date of enactment of this Act.

○

68 649 18

II

101ST CONGRESS
1ST SESSION

S. 651

To amend the Trust Indenture Act of 1939.

IN THE SENATE OF THE UNITED STATES

MARCH 17 (legislative day, JANUARY 3), 1989

Mr. DODD (for himself and Mr. HEINZ) (by request) introduced the following bill; which was read twice and referred to the Committee on Banking, Housing, and Urban Affairs

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A BILL

To amend the Trust Indenture Act of 1939.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. This Act may be cited as the "Trust Indenture Reform Act of 1989".

SEC. 2. Section 303(8) of the Trust Indenture Act of 1939 (15 U.S.C. 77ccc(8)) is amended by inserting "section 305 or" after "provided for in".

SEC. 3. Section 304 of the Trust Indenture Act of 1939 (15 U.S.C. 77ddd) is amended—

(1) by striking ", as heretofore amended," in subsection (a)(4)(A); and

(2) by striking subsection (d) and inserting in lieu thereof the following:

"(d) The Commission may, by rules or regulations upon its own motion, or by order on application by an interested person, exempt conditionally or unconditionally any person, security, or transaction, or any class or classes of persons, securities, or transactions, from any one or more of the provisions of this title, if and to the extent that such exemption is necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by this title. The Commission shall by rules and regulations determine the procedures under which an exemption under this subsection shall be granted, and may, in its sole discretion, decline to entertain any application for an order of exemption under this subsection.".

SEC. 4. Section 305(b) of the Trust Indenture Act of 1939 (15 U.S.C. 77eee(b)) is amended—

(1) by striking "The" and inserting "(1) Except as may be permitted by paragraph (2) of this subsection, the";

(2) by redesignating paragraph (1) as subparagraph (A) and inserting "or" at the end thereof;

(3) by striking paragraph (2);

(4) by redesignating paragraph (3) as subparagraph (B); and

(5) by adding at the end thereof the following:

"(2) In the case of securities registered under the Securities Act of 1933, which securities shall not be sold until a date subsequent to the effective date of the registration statement relating to such securities, the Commission shall not be required to issue the order described in paragraph (1) if, prior to the sale of such securities, the obligor of such securities has filed an application for qualification for the indenture under which such securities shall be issued pursuant to such rules and regulations as the Commission may prescribe. The Commission shall issue an order prior to the effective date of such an application for qualification refusing to permit such application to become effective, if it finds that—

"(i) the security to which such application relates has not been or is not to be issued under an indenture; or

"(ii) any person designated as trustee under such indenture is not eligible to act as such under subsection (a) of section 310 or has any conflicting interest as defined in subsection (b) of section 310;

but no such order shall be issued except after notice and opportunity for hearing within the periods and in the manner required with respect to refusal orders pursuant to section 8(b) of the Securities Act of 1933. If and when the Commission deems that the objections on which such order was based

have been met, the Commission shall enter an order rescinding such refusal order, and the application shall become effective at the time provided in section 8(a) of the Securities Act of 1933, or upon the date of such rescission, whichever shall be the later.".

SEC. 5. Paragraph (2) of section 309(a) of the Trust Indenture Act of 1939 (15 U.S.C. 77iii(a)) is amended by inserting "section 305 or" after "pursuant to".

SEC. 6. Section 310(a) of the Trust Indenture Act of 1939 (15 U.S.C. 77jjj(a)) is amended—

(1) by inserting at the end of paragraph (1) the following: "The Commission may, pursuant to such rules and regulations as it may prescribe, or by order on application, permit a corporation or other person organized and doing business under the laws of a foreign government to act as sole trustee under an indenture qualified or to be qualified pursuant to this title if—

"(A) such corporation or other person—

"(i) is authorized under such laws to exercise corporate trust powers; and

"(ii) is subject to supervision or examination by authority of such foreign government or a political subdivision thereof substantially equivalent to supervision or examination applicable to United States institutional trustees; and

"(B) under such laws, a United States institutional trustee is eligible to act as sole trustee under an indenture relating to securities sold within the jurisdiction of such foreign government.";

(2) by striking "The indenture to be qualified shall require that there" in paragraph (1) and inserting "There";

(3) by striking "The indenture to be qualified shall require that such" in paragraph (2) and inserting "Such";

(4) by striking "such indenture shall provide that" in paragraph (3); and

(5) by striking "the indenture to be qualified shall require that" from paragraph (4), and inserting "shall" after "the indenture trustee or trustees".

SEC. 7. Section 310(a) of the Trust Indenture Act of 1939 (15 U.S.C. 77jjj(a)) is amended by adding at the end the following:

"(5) No obligor upon the indenture securities or person directly or indirectly controlling, controlled by, or under common control with such obligor shall serve as trustee upon such indenture securities.".

SEC. 8. Section 310(b) of the Trust Indenture Act of 1939 (15 U.S.C. 77jjj(b)) is amended to read as follows:

"(b) DISQUALIFICATION OF TRUSTEE.—If any indenture trustee has or shall acquire any conflicting interest as hereinafter defined, (i) such trustee shall, within 90 days after ascertaining that it has such conflicting interest, either eliminate such conflicting interest or resign, and the obligor upon the indenture securities shall take prompt steps to have a successor appointed in the manner provided in the indenture; (ii) in the event that such trustee fails to comply with the provisions of clause (i) of this subsection, such trustee shall, within 10 days after the expiration of such 90-day period, transmit notice of such failure to the indenture security holders in the manner and to the extent provided in subsection (c) of section 313; and (iii) subject to the provisions of subsection (e) of section 315, any security holder who has been a bona fide holder of indenture securities for at least 6 months may, on behalf of himself and all others similarly situated, petition any court of competent jurisdiction for the removal of such trustee, and the appointment of a successor, if such trustee fails, after written request therefor by such holder to comply with the provisions of clause (i) of this subsection.

"For the purposes of this subsection, an indenture trustee shall be deemed to have a conflicting interest if the indenture securities are in default (as such term is defined in such indenture, but exclusive of any period of grace or requirement of notice) and—

"(1) such trustee is trustee under another indenture under which any other securities, or certificates of interest or participation in any other securities, of an obligor upon the indenture securities are outstanding or is trustee for more than one outstanding series of securities, as hereafter defined, under a single indenture of an obligor, unless (A) the indenture securities are collateral trust notes under which the only collateral consists of securities issued under such other indenture, or (B) such other indenture is a collateral trust indenture under which the only collateral consists of indenture securities, or (C) such obligor has no substantial unmortgaged assets and is engaged primarily in the business of owning, or of owning and developing or operating, real estate, and the indenture to be qualified and such other indenture are secured by wholly separate and distinct parcels of real estate: *Provided*, That the indenture to be qualified may contain a provision excluding from the operation of this paragraph other series under such indenture, another indenture or indentures under which other securities, or certificates of interest or participation in other securities, of such an obligor are outstanding, if (i) the indenture to be qualified and any such other indenture or indentures are wholly unsecured, and such other indenture or inden-

tures are specifically described in the indenture to be qualified or are thereafter qualified under this title, unless the Commission shall have found and declared by order pursuant to subsection (b) of section 305 or subsection (c) of section 307 that differences exist between the provisions of the indenture to be qualified and the provisions of such other indenture or indentures which are so likely to involve a material conflict of interest as to make it necessary in the public interest or for the protection of investors to disqualify such trustee from acting as such under one of such indentures, or (ii) the issuer shall have sustained the burden of proving, on application to the Commission and after opportunity for hearing thereon, that trusteeship under the indenture to be qualified and such other indenture or under more than one outstanding series under a single indenture is not so likely to involve a material conflict of interest as to make it necessary in the public interest or for the protection of investors to disqualify such trustee from acting as such under one of such indentures or series;

"(2) such trustee or any of its directors or executive officers is an underwriter for an obligor upon the indenture securities;

"(3) such trustee directly or indirectly controls or is directly or indirectly controlled by or is under direct or indirect common control with an underwriter for an obligor upon the indenture securities;

"(4) such trustee or any of its directors or executive officers is a director, officer, partner, employee, appointee, or representative of an obligor upon the indenture securities, or of an underwriter (other than the trustee itself) for such an obligor who is currently engaged in the business of underwriting, except that (i) one individual may be a director and/or an executive officer of the trustee and a director and/or an executive officer of such obligor, but may not be at the same time an executive officer of both the trustee and of such obligor, (ii) if and so long as the number of directors of the trustee in office is more than 9, one additional individual may be a director and/or an executive officer of the trustee and a director of such obligor, and (iii) such trustee may be designated by any such obligor or by any underwriter for any such obligor, to act in the capacity of transfer agent, registrar, custodian, paying agent, fiscal agent, escrow agent, or depositary, or in any other similar capacity, or, subject to the provisions of paragraph (1) of this subsection, to act as trustee, whether under an indenture or otherwise;

"(5) 10 per centum or more of the voting securities of such trustee is beneficially owned either by an obligor upon the indenture securities or by any director, partner, or executive officer thereof, or 20 per centum or more of such voting securities is beneficially owned, collectively by any 2 or more of such persons; or 10 per centum or more of the voting securities of such trustee is beneficially owned either by an underwriter for any such obligor or by any director, partner, or executive officer thereof, or is beneficially owned, collectively, by any 2 or more such persons;

"(6) such trustee is the beneficial owner of, or holds as collateral security for an obligation which is in default as hereinafter defined, (i) 5 per centum or more of the voting securities, or 10 per centum or more of any other class of security, or an obligor upon the indenture securities, not including indenture securities and securities issued under any other indenture under which such trustee is also trustee, or (ii) 10 per centum or more of any class of security of an underwriter for any such obligor;

"(7) such trustee is the beneficial owner of, or holds as collateral security for an obligation which is in default as hereinafter defined, 5 per centum or more of the voting securities of any person who, to the knowl-

edge of the trustee, owns 10 per centum or more of the voting securities of, or controls directly or indirectly or is under direct or indirect common control with, an obligor upon the indenture securities;

"(8) such trustee is the beneficial owner of, or holds as the collateral security for an obligation which is in default as hereinafter defined, 10 per centum or more of any class of security of any person who, to the knowledge of the trustee, 50 per centum or more of the voting securities of an obligor upon the indenture securities;

"(9) such trustee owns, on the date of default upon the indenture securities (as such term is defined in such indenture but exclusive of any period of grace or requirement of notice) or any anniversary of such default while such default upon the indenture securities remains outstanding, in the capacity of executor, administrator, testamentary or inter vivos trustee, guardian, committee or conservator, or in any other similar capacity, an aggregate of 25 per centum or more of the voting securities, or of any class of security, of any person, the beneficial ownership of a specified percentage of which would have constituted a conflicting interest under paragraphs (6), (7), or (8) of this paragraph. As to any such securities of which the indenture

trustee acquired ownership through becoming executor, administrator or testamentary trustee of an estate which include them, the provisions of the preceding sentence shall not apply for a period of not more than 2 years from the date of such acquisition, to the extent that such securities included in such estate do not exceed 25 per centum of such voting securities or 25 per centum of any such class of security. Promptly after the dates of any such default upon the indenture securities and annually in each succeeding year that the indenture securities remain in default the trustee shall make a check of its holding of such securities in any of the above-mentioned capacities as of such dates. If the obligor upon the indenture securities fails to make payment in full of principal or interest under such indenture when and as the same becomes due and payable, and such failure continues for 30 days thereafter, the trustee shall make a prompt check of its holdings of such securities in any of the above-mentioned capacities as of the date of the expiration of such 30-day period, and after such date, notwithstanding the foregoing provisions of this paragraph, all such securities so held by the trustee, with sole or joint control over such securities vested in it, shall be considered as

though beneficially owned by such trustee, for the purposes of paragraphs (6), (7), and (8); or

"(10) except under the circumstances described in paragraphs (1), (3), (4), (5) or (6) of section 311(b) of this title, the trustee shall be or shall become a creditor of the obligor.

"For purposes of this subsection and of section 316(a) of this title, the term 'series of securities' or 'series' means a series, class or group of securities issuable under an indenture pursuant to whose terms holders of one such series may vote to direct the indenture trustee, or otherwise take action pursuant to a vote of such holders, separately from holders of another such series: *Provided*, That 'series of securities' or 'series' shall not include any series of securities issuable under an indenture if all such series are wholly unsecured, unless the Commission shall have found and declared by order pursuant to subsection (b) of section 305 or subsection (c) of section 307 that differences exist between the series under the indenture which are so likely to involve a material conflict of interest as to make it necessary in the public interest or for the protection of investors to disqualify such trustee from acting under one such series.

"The specification of percentages in paragraphs (5) through (9) shall not be construed as indicating that the ownership of such percentages of the securities of a person is or is

not necessary or sufficient to constitute direct or indirect control for the purposes of subparagraph (3) or (7).

"For the purposes of paragraphs (6), (7), (8), and (9)—

"(A) the terms 'security' and 'securities' shall include only such securities as are generally known as corporate securities, but shall not include any note or other evidence of indebtedness issued to evidence an obligation to repay moneys lent to a person by one or more banks, trust companies, or banking firms, or any certificate of interest or participation in any such note or evidence of indebtedness;

"(B) an obligation shall be deemed to be in default when a default in payment of principal shall have continued for 30 days or more, and shall not have been cured; and

"(C) the indenture trustee shall not be deemed the owner or holder of (i) any security which it holds as collateral security (as trustee or otherwise) for any obligation which is not in default as above defined, or (ii) any security which it holds as collateral security under the indenture to be qualified, irrespective of any default thereunder, or (iii) any security which it holds as agent for collection, or as custodian, escrow agent or depositary, or in any similar representative capacity.

"For the purposes of this subsection, the term 'underwriter' when used with reference to an obligor upon the indenture securities means every person who, within 1 year prior to the time as of which the determination is made, was an underwriter of any security of such obligor outstanding at the time of the determination.

"Except in the case of a default in the payment of the principal of or interest on any indenture security, or in the payment of any sinking or purchase fund installment, the indenture trustee shall not be required to resign as provided by this subsection if such trustee shall have sustained the burden of proving, on application to the Commission and after opportunity for hearing thereon, that (A) the default under the indenture may be cured or waived during the period and under the procedures described in such application, and (B) a stay of the trustee's duty to resign will not be inconsistent with the interests of holders of the indenture securities.

"Any resignation of an indenture trustee shall become effective only upon the appointment of a successor trustee and such successors's acceptance of such an appointment.".

SEC. 9. Section 311(a) of the Trust Indenture Act of 1939 (15 U.S.C. 77kkk(a)) is amended—

(1) by striking "the indenture to be qualified shall provide that";

(2) by striking "four" in all references to "four months" or "four months' " and inserting "3" in lieu thereof; and

(3) by adding the following at the end of the subsection:

"In any case commenced under the Bankruptcy Act of July 1, 1898, or any amendment thereto enacted prior to November 6, 1978, all references to periods of 3 months shall be deemed to be references to periods of 4 months.".

SEC. 10. Section 312 of the Trust Indenture Act of 1939 (15 U.S.C. 77lll) is amended—

(1) in subsection (a), by striking "The indenture to be qualified shall contain provisions requiring each obligor upon the indenture securities to" and inserting in lieu thereof "Each obligor upon indenture securities shall"; and

(2) in subsection (b), by striking "The indenture to be qualified shall also contain provisions requiring that, within" and inserting in lieu thereof "Within".

SEC. 11. Section 313(a) of the Trust Indenture Act of 1939 (15 U.S.C. 77mmm(a)) is amended—

(1) by striking "The indenture to be qualified shall contain provisions requiring the indenture trustee to" and inserting in lieu thereof "The indenture trustee shall";

(2) by inserting "any of the following events which may have occurred within the previous 12 months; if no such event has occurred within such period no report need be filed;" after "a brief report with respect to";

(3) by inserting at the beginning of paragraphs (1), (3) and (4) "any change to"; and

(4) by striking from paragraph (1) ", or in lieu thereof, if to the best of its knowledge it has continued to be eligible and qualified under such section, a written statement to such effect".

SEC. 12. Section 313 of the Trust Indenture Act of 1939 (15 U.S.C. 77mmm) is amended—

(1) in subsection (b), by striking "The indenture to be qualified shall also contain provisions requiring the indenture trustee to" and inserting in lieu thereof "The indenture trustee shall"; and

(2) in subsection (c), by striking "The indenture to be qualified shall also provide that reports" and inserting in lieu thereof "Reports"; and

(3) in subsection (d), by striking "The indenture to be qualified shall also provide that a copy" and inserting in lieu thereof "A copy".

SEC. 13. Section 314 of the Trust Indenture Act of 1939 (15 U.S.C. 77nnn) is amended—

(1) in subsection (a)—

(A) by striking "The indenture to be qualified shall contain provisions requiring each" and inserting in lieu thereof "Each";

(B) by inserting "shall" after "thereby";

(C) by striking "to" at the beginning of paragraphs (1), (2), and (3);

(D) by striking "and" at the end of paragraph (2);

(E) by striking the period at the end of paragraph (3) and inserting in lieu thereof "; and"; and

(F) by inserting at the end of paragraph (3) the following new paragraph:

"(4) file with the indenture trustee, at stated intervals of not more than 12 months, a brief certificate from two officers of such obligor as to their knowledge of such obligor's compliance with all conditions and covenants under the indenture. For purposes of this subsection, such compliance shall be determined without regard to any period of grace or requirement of notice provided under the indenture.";

(2) in subsection (b)—

(A) by striking "such indenture shall contain provisions requiring"; and

(B) by striking "to furnish" and inserting in lieu thereof "shall furnish";

(3) in subsection (c)—

(A) by striking "The indenture to be qualified shall contain provisions requiring the obligor" and inserting in lieu thereof "The obligor"; and

(B) by striking "to furnish" and inserting in lieu thereof "shall furnish";

(4) in subsection (d)—

(A) by striking "such indenture shall contain provisions" and inserting in lieu thereof "the obligor upon the indenture securities shall furnish to the indenture trustee a certificate or opinion of an engineer, appraiser, or other expert as to the fair value"; and

(B) by striking "requiring the obligor upon the indenture securities to furnish to the indenture trustee a certificate or opinion of an engineer, appraiser or other expert as to the fair value" from paragraphs (1), (2), and (3).

SEC. 14. Section 315 of the Trust Indenture Act of 1939 (15 U.S.C. 77ooo) is amended—

(1) in subsection (a), by striking "such indenture shall contain provisions requiring the indenture trustee

to examine" and inserting in lieu thereof "the indenture trustee shall examine";

(2) in subsection (b), by striking "The indenture to be qualified shall contain provisions requiring the indenture trustee to" and inserting in lieu thereof "The indenture trustee shall"; and

(3) in subsection (c), by striking "The indenture to be qualified shall contain provisions requiring the indenture trustee to" and inserting in lieu thereof "The indenture trustee shall".

SEC. 15. Section 316 of the Trust Indenture Act of 1939 (15 U.S.C. 77ppp) is amended—

(1) in paragraphs (1) and (2) of subsection (a), by inserting "or of the series of securities" after "principal amount of the indenture securities";

(2) in subsection (b), by striking "The indenture to be qualified shall provide that, notwithstanding any other provision thereof," and inserting in lieu thereof "Notwithstanding any other provision thereof, the indenture shall provide that"; and

(3) by adding at the end the following new subsection:

"(c) The obligor upon any indenture qualified under this title may set a record date for purposes of determining the identity of indenture security holders entitled to vote or con-

sent to any action by vote or consent authorized or permitted by subsection (a) of this section. Unless the indenture provides otherwise, such record date shall be the later of not more than 30 days prior to the first solicitation of such consent or the date of the most recent list of holders furnished to the trustee pursuant to section 312 of this title prior to such solicitation.".

SEC. 16. Section 317 of the Trust Indenture Act of 1939 (15 U.S.C. 77qqq) is amended—

(1) in subsection (a), by striking "to be qualified shall contain provisions" and inserting in lieu thereof "trustee shall be authorized";

(2) by striking "authorizing the indenture trustee" in paragraphs (1) and (2) of subsection (a); and

(3) in subsection (b), by striking "The indenture to be qualified shall provide that each" and inserting in lieu thereof "Each".

SEC. 17. Section 318 of the Trust indenture Act of 1939 (15 U.S.C. 77rrr) is amended—

(1) by striking subsection (a) and inserting in lieu thereof the following:

"(a) If any provision of the indenture to be qualified limits, qualifies, or conflicts with the duties imposed by operation of subsection (c) of this section, the imposed duties shall control."; and

(2) by adding at the end the following new subsections:

"(c) Those provisions of sections 310 through 317, inclusive, that impose duties upon any person are a part of and govern every qualified indenture, whether or not they are physically contained therein. Those provisions of sections 310 through 317, inclusive, that may be included at the option of the obligor are not a part of such an indenture unless they are specifically included.

"(d) The provisions of this title shall be deemed to apply to any indenture heretofore or hereafter qualified under this title.".

SEC. 18. Section 322(b) of the Trust Indenture Act of 1939 (15 U.S.C. 77vvv(b)) is amended by inserting "or duty" after "any liability".

O

SECURITIES INDUSTRY ASSOCIATION
1850 M Street, N. W., Washington, D. C. 20036 • (202) 296-9410

EDWARD I. O'BRIEN
President

April 7, 1989

The Honorable Christopher J. Dodd
United States Senate
Committee on Banking, Housing
& Urban Affairs
Subcommittee on Securities
Washington, DC 20510

Dear Mr. Chairman:

On behalf of the Securities Industry Association, I would like to voice my strong support for an increased level of funding for the Securities and Exchange Commission.

The SEC has in the past several years overseen explosive growth in virtually all areas of our nation's securities markets. For example, in the area of disclosure review, which is the cornerstone of federal securities regulation, the number of new registration statements filed annually has more than doubled since 1980. The number of tender offer schedules has increased 699 percent. Moreover, securities offered to the public have become increasingly complex, particularly those associated with the huge increase in foreign offerings. However the staff available for these tasks has remained virtually static since 1980.

Consequently, there are delays in the reviewing certain documents, such as offering statements, which impedes the capital-raising process for companies. In addition an increasing number of disclosure documents are either partially reviewed or not reviewed at all, potentially raising questions about the adequacy of disclosure to investors. For example, while the SEC expects to review 78 percent of all new registration statements filed this year, only 12 percent of annual reports will be reviewed.

Similar problems of adequate staffing beset both market regulation and the investment management division. Here too, the story is one of enormous market growth, without the concomitant growth in resources. Since 1980 the number of firms and employees registered with the Commission has increased 88 percent and 148 percent respectively.

Trading volume on the exchanges is up 300 percent and over-the-counter activity increased 465 percent. The October 1987 market break further exacerbated pressures on financial and human resources as the Commission has been called upon to evaluate myriad proposals designed to respond to a new trading environment.

A particular problem has mushroomed in the investment management area where these has been a 146 percent increase in the number of investment companies with a 945 percent increase in the assets they manage for 25 percent of the households in the United States. These managed assets totaled $4.4 trillon-greater than the combined deposits of all banks and savings and loans. While SEC staffing in this area has increased some 13 percent, the inspection cycle has been stretched to where some question the deterrent effect of such inspections.

Mr. Chairman, SIA believes that investor confidence in the markets is critical, if investors are to continue participating actively in the those markets. No one in our industry benefits if the SEC is under-funded and ill-equipped to detect, pursue and prosecute those who betray the public's trust. Though we as an industry may disagree with the Commission from time to time, we support the work of the SEC and strongly believe that this agency must have additional resources if it is to carry out its statutory responsibilities in today's market.

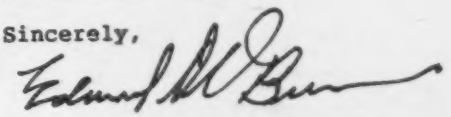
SIA and several chief executives from the securities industry testified early in the last Congress about the need for substantially increased funding for the SEC. Time has not alleviated our concerns. To the contrary, both the events of October, 1987, and the continuing growth of our markets and institutions under the SEC's oversight have increased the urgency of such needs.

Finally, we point out that the industry and the investing public simply are not getting what we are paying for. The SEC in 1988 collected $249 million in fees from various sources, while its authorized budget was only $143 million. Thus, the SEC was a profit center for the government, to the tune of over $100 million. In addition, in 1987 and 1988, the SEC's enforcement efforts resulted in the payment of almost $64 million in civil penalties to the U.S. Treasury.

Certainly, a greater portion of what the industry, companies and investors pay into the SEC should be utilized to preserve our markets as the freest and finest in the world.

Thank you for your consideration of our views.

Sincerely,



National Association
of Manufacturers

ALEXANDER B. TROWBRIDGE
President

April 12, 1989

The Honorable Christopher J. Dodd
Chairman
Subcommittee on Securities of the
Committee on Banking, Housing
and Urban Affairs
United States Senate
Washington, D.C. 20510

Dear Mr. Chairman:

On behalf of the National Association of Manufacturers, I urge you and your colleagues on the Senate Banking Committee to increase funding for the Securities and Exchange Commission's fiscal year 1990.

Funding the SEC's oversight activities has been a sound investment for the U.S. taxpayer. In 1988 the SEC's budget was approximately $135.2 million and, operating within this budget, the Commission brought in filing fees amounting to approximately $249 million going to the U.S. Treasury.

U.S. manufacturers annually contribute a significant amount to the total fees collected by the SEC. As financial participants in the nation's economy, we believe our dollars are well invested and result in a safer financial system. Our nation's recent experience with the thrift industry has shown that dollars saved by limited federal oversight pale in comparison to the dollars lost through mismanagement and fraud.

There is currently widespread concern that the Commission has not received sufficient funds to even maintain past staffing levels. Given the increased complexities of our financial markets, the growing concern by small investors in reported fraudulent activity and, consequently, the increased demands placed upon the Commission, the NAM believes it is essential that present proposed funding levels be increased.

Thank you for your consideration on this important matter.

Sincerely,

Sandy Trowbridge

1331 Pennsylvania Ave. NW
Suite 1500 - North Lobby
Washington, D.C. 20004-1703
(202)637-3012

INVESTMENT COMPANY INSTITUTE

DAVID SILVER
President

April 24, 1989

The Honorable Christopher J. Dodd
Chairman
Subcommittee on Securities
SR-444 Russell
Washington, D.C. 20510

Dear Mr. Chairman:

I am writing on behalf of the Investment Company Institute to express our belief that the level of funding for the Securities and Exchange Commission is inadequate and should be substantially increased.

We are concerned that unprecedented and growing complexities of the securities markets, when combined with the pressures of national budgetary considerations, may threaten the SEC's ability to pursue vigorously -- as it has with distinction for the past fifty-five years -- its fundamental statutory mandate to act in "the public interest" for the "protection of investors." While the mission and apparent scope of the SEC's responsibilities have remained essentially constant over the years, the problems it faces domestically and internationally, and the sheer volume of activity within its regulatory ambit, pose vast new challenges.

The Committee has before it statistical data as to the substantial increase in the Commission's workload in recent years, which make a compelling case for substantial budget increases. I thought it might be helpful to take an even longer overview -- 25 years -- which suggests that there may have been an even greater erosion of the SEC's capabilities than is suggested by short-term comparisons.

The starting point is the SEC's human resources. In 1963, the SEC was authorized to have 1,481 employees. I understand that under current budgetary constraints the Commission may be limited to 2,050 in the coming year. This would represent a 38 percent increase in staff over the past quarter century. But a

1600 M Street, N.W. Washington, D.C. 20036 202 293-7700

comparative review of SEC supervised activities as between 1963 and 1988 raises serious doubts as to whether the SEC has the human resources to discharge effectively its responsibilities.

In 1963, the average daily volume of trading on the New York Stock Exchange was 4,566,000 million shares per day; in 1988 trading volume equalled 164,460,000 million shares per day -- an increase of 3502 percent.

In 1963 there were 5,482 registered broker-dealers and 679 applications for new registrations; in 1988 there were 12,140 registered broker-dealers and 2,204 new applications -- an increase of 121 percent in registrations and 225 percent in applications.

In 1963 there were 1,564 registered investment advisers and 285 new applications; in 1988 there were 14,120 registered investment advisers and 3,360 new applications -- an increase of 803 percent in registrations and 1079 percent in applications.

In 1963 there were 727 registered investment companies with 48 new registrants; in 1988 there were 3,500 registered investment companies and 1,569 new registrations -- an increase of 381 percent in registered companies and 3169 percent in new registrations.

In 1963 the first major insider trading case -- Texas Gulf Sulphur -- was still in the future; in 1988 the "big" case is almost routine. In 1963 internationalization posed no enforcement problems. Today a growing number of securities frauds have an international aspect.

In 1963 there was no separate enforcement division at the SEC; what existed was a small office of a few dozen employees located within the predecessor of today's Division of Market Regulation. Today the Division of Enforcement is a major arm of the SEC employing 749 people.

In 1963 user fees collected by the U.S. Treasury under the securities laws accounted for only 19 percent of the SEC's budget; in 1988 such fees accounted for 184 percent of the SEC's budget.

The tremendous increases in the number of broker-dealers, investment companies, investment advisers, and trading volume are

typical of the securities markets as a whole. This growth has created enormous quantitative differences and important qualitative changes in the kind of regulatory oversight and enforcement activities required of the SEC.

For example, increased public participation in the markets and revolutionary developments in communications technology have served to create an environment conducive to the perpetration of widescale fraud on a nationwide basis -- as in the current "penny stock" phenomenon -- which, in the absence of an enforcement capability with a swift response time, can harm many thousands of small investors before being stopped. At the same time, new, complex financing and trading techniques and internationalization have given rise to "big" cases which consume tremendous enforcement energies. Some cases may simply not be pursued because of insufficient resources.

Additionally, competitive developments and innovation within the securities industry, over time, creates the need for new and different regulation -- regulation which protects the public but also affords industry the flexibility necessary to foster healthy innovation and robust competition both nationally and internationally. An understaffed agency is much more likely to miss the mark in one direction or the other -- and either overregulate or underregulate.

Thus, whether one takes a short or long view, it is clear that the SEC is underfunded and understaffed. The greatest irony is found by comparing user fees collected by the U.S. Treasury under the securities laws: In 1963 these user fees represented a small fraction of the total SEC budget; currently user fees are approaching twice the size of the current budget. Clearly, 1963 investor protection activities conducted by the SEC were considered to be critical enough to warrant the expenditure of general revenues to subsidize these activities. Now, investors and industry are being required to pay far more than the SEC receives in appropriated funds. The investing public and the industry are thus not receiving the services from government which they need, and, as these figures show, they are not receiving the services for which they pay. This should be rectified.

Thank you for the opportunity to present our views. We would be most happy to provide you with such other information which you might find helpful.

Sincerely yours,

David Silver

National Independent Energy Producers

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(202) 783-2244

March 31, 1989

The Honorable Christopher J. Dodd
Chairman
Subcommittee on Securities
534 Dirksen Senate Office Building
Washington, D.C.

Dear Senator Dodd:

I am writing on behalf of the National Independent Energy Producers to express concern about understaffing of the Division of Investment Management of the Securities and Exchange Commission (SEC). We understand you will be considering the SEC's budget at authorization hearings on April 6.

As you know, the Office of Public Utility Regulation within the Investment Management Division administers the Public Utility Holding Company Act of 1935 (PUHCA). While PUHCA's original goal of protecting investors and consumers from the monopoly power of utility holding companies remains laudable, the inability of the Office of Public Utility Regulation to cope with its growing workload may aggravate the increasing energy needs of this country.

You are undoubtedly aware that serious shortages of electric generating capacity are developing in several regions. A number of utilities on the East Coast actually experienced brown-outs during the summer of 1988. By the late 1990s, it is anticipated that between 60,000 and 100,000 MWs of generating capacity will be needed.

The members of the National Independent Energy Producers (NIEP) offer part of the solution to this problem. The association includes companies which generate electricity for sale to utilities from a variety of resources including coal, gas, waste, hydro, wood, geothermal, solar and wind.

Overall, the independent energy industry now accounts for 3.5% of the nation's electricity generation, with about 25,000 MWs of capacity in operation, and an additional 45,000 MWs under development. Moreover, experts anticipate that the independent sector will be called upon to provide 50% of all new capacity in the next decade.

Metropolitan Square, Suite 205 655 Fifteenth Street, N.W. Washington, D.C. 20005

Although most NIEP members were initially involved in the development of qualifying facilities* ("QF") which are exempt from the requirements of PUHCA, the opportunities to develop QFs are decreasing in number. By definition, QFs must utilize a renewable fuel resource (such as hydro, geothermal or wind) or sell a certain quantity of thermal energy to a steam host.

Most QFs, therefore, cannot be moved to different locations, and most of the promising locations have already been developed. In addition, it is difficult to adapt QFs to the pressing need which utilities have for "peakers;" i.e., plants which generate electricity only during the few hours each year when the demand for electricity is greatest. Consequently, several NIEP members and many other companies are ready to expand into "independent power" projects, or IPPs.

IPPs are generators of electricity which lack market power and, therefore, need not be closely regulated as traditional utilities are. Unlike QFs, however, IPPs are not exempt from the strictures of PUHCA. Before an IPP can commence the generation of power, it must seek a determination from the Office of Public Utility Regulation either that it qualifies for an exemption from PUHCA or that no enforcement action will be taken because is falls outside PUHCA.

In practical terms, an IPP cannot even commence construction without such a determination from the SEC because banks and other lending institutions demand that this clearance be in-hand before they provide financing. Thus, the ability to obtain an SEC clearance expeditiously determines how quickly an IPP can commence construction, and new generating capacity can be brought on-line.

To date, relatively few IPPs have filed applications with the Office of Public Utility Regulation, but a substantial increase is expected in the very near future. Experts estimate that there are 20-25 IPPs in the planning stages. Of the 11 employees in the Office of Public Utility Regulation, however, only two handle applications from IPPs, and these individuals are already overburdened with their current workload. In order to ensure that IPPs will be available to meet the immediate need for power across the country, the Office of Public Utility Regulation must be given additional resources to process the applications relating to these projects.

We would appreciate your attention to this matter in the forthcoming SEC budget authorization hearings and any relief you might offer. If you need additional information or if we can be of any other assistance, please do not hesitate to contact me.

Sincerely,

Merribel S. Ayres

cc: Marty Cochran

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* As defined by the Public Utility Regulatory Policies Act of 1978 (PURPA).

AMERICAN
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AGENCY RELATIONS,
TRUST AND SECURITIES

DIRECTOR
James D. McLaughlin
202/663-5324

April 14, 1989

The Honorable Christopher J. Dodd
444 Senate Russell
Office Building
Constitution Avenue
Washington, DC 20510-0701

RE: The Shareholder Communications Improvement Act of 1989

Dear Senator Dodd:

The American Bankers Association ("ABA") appreciates the opportunity to present its views on the Shareholder Communications Improvement Act of 1989, S. 649. The ABA is the national banking trade association representing banks of all sizes and types, and in all locations. The assets of our membership represent approximately 95% of the industry total.

Section 649, introduced on March 17, 1989 and referred to the Committee on Banking, Housing and Urban Affairs, is designed to improve the flow of corporate information to mutual fund and investment company shareholders. As introduced, the legislation would require members of exchanges, brokers, dealers, banks, associations, or other entities exercising fiduciary powers as nominees to:

1. provide proxy and other shareholder communications to investment company beneficial security holders;

2. supply investment company registrants, upon request, with beneficial owner information regarding investment company beneficial security holders;

3. transmit information statements to all beneficial security holders.

The legislation also would require investment companies to deliver information statements to all security holders prior to any security holder vote when proxies, consents or authorizations are not solicited.

The ABA has no objection to the proposed legislation. The ABA would note, however, that before the legislation becomes effective, the Securities and Exchange Commission ("Commission") should provide, in its rules, sufficient lead time for banks and other nominees to establish in-house programs and procedures for adding investment company security holders to its existing shareholder communications procedures. For example, investment company beneficial security holders will have to be solicited to determine whether or not they consent to disclosure of their names, addresses and securities positions to investment company registrants.

Lead time also will be necessary for establishing programs and procedures for delivery of information statements to all beneficial security holders. In this regard, the ABA assumes that the Commission will promulgate rules regarding the appropriate timing for delivery of information statements.

The Commission also should provide in its rules for banks, brokers and other nominees to recoup start-up costs. Nominees were permitted under the Commission's shareholder communications rules to assess over a two-year period a start-up cost of $.385 per proxy solicited. This fee was intended to fund the cost of setting up the shareholder communications system. A similar provision should be incorporated into the Commission's shareholder communications rules to permit recoupment of start-up costs associated with the enactment of S. 649.

If the ABA can be of any further assistance, please do not hesitate to call this office.

Sincerely,

James D. McLaughlin

cc: Katherine McGrath
Nina Gross
Mauri Osheroff

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April 21, 1989

Senator Christopher J. Dodd
Chairman,
Subcommittee on Securities
Banking, Housing and Urban Affairs Committee
United States Senate
SD-534 Dirksen Senate Office Building
Washington, DC 20510

Dear Senator Dodd,

This letter is submitted by the Special Committee on Securities Law and Disclosure of the National Association of Bond Lawyers in connection with the recent testimony of David Ruder, Chairman of the Securities and Exchange Commission, before the Subcommittee on Securities of the Senate Banking, Housing and Urban Affairs Committee.

The Special Committee wishes to express support for Chairman Ruder's request for an increase in funds appropriated to the Securities and Exchange Commission. While we may not be in total agreement with the features of the Commission's proposed Rule 15c2-12 (our comments are set forth in the attached letter, previously filed with the Commission), we voice our strong support for an adequately funded Commission. The anti-fraud provisions of the federal securities laws have long served as an effective, efficient tool prompting full and fair disclosure in the municipal market. A well funded enforcement division standing behind the anti-fraud provisions will continue to enhance the quality of disclosure in the municipal marketplace.

We urge you to provide an increase in funds appropriated to the Commission for the greater benefit of all participants in the municipal marketplace.

Very truly yours,

Paul S. Maco
Chairman

cc: Senator Donald W. Riegle, Jr.
Hon. David S. Ruder

2766A

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May 1, 1989

Senator Christopher Dodd
Chairman, Securities Subcommittee
Senate Committee on Banking, Housing
and Urban Affairs
Russell Senate Office Building Room 444
Washington, D.C. 20510

Dear Senator Dodd:

This letter is submitted by the Committee on Federal Regulation of Securities of the American Bar Association regarding the problem of adequately funding the Securities and Exchange Commission ("SEC"). It was prepared by members of the Subcommittee on SEC Administration, Budget and Legislation of the Committee on Federal Regulation of Securities, Section of Business Law. A draft of this letter was circulated for comment among the members of the Subcommittee and has received the general agreement of a majority of those who responded to the draft. This letter does not, however, represent the official view of the American Bar Association, the Section or the Committee nor does it necessarily reflect the views of all members of the Subcommittee or of those who reviewed the letter.

Members of our Committee deal regularly and routinely with the SEC on behalf of clients. A substantial number of us have worked for the SEC during our careers. We are thus personally familiar with the operations of the SEC and are able to assess its needs. We also are in a position to experience the growing frustration of doing business with an agency which, despite a highly-skilled and dedicated staff, is often overwhelmed by its workload.

We have reviewed the December 20, 1988 Self-Funding Study prepared by the Executive Director of the SEC and submitted in partial response to the request of the Securities Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs. We are in general accord with the Executive Director's description of the problems the Commission faces and of the need to resolve those problems. We also support the study's specific requests for authority to

- set staff salaries on a competitive basis and provide for regional pay differentials;
- offer performance-based retention bonuses to its professional staff;
- fill 100 positions at executive pay scale compensation levels with highly qualified professionals;
- develop and implement pay bands for classifying professional and support staff positions; and
- lease and manage its own space.

Finally, we believe the methods proposed in the Study to resolve budgetary difficulties are promising and offer a starting point from which Congress may begin to fashion a means for responding to the SEC and its constituencies' needs.

We stand ready to assist you further in this matter.

Sincerely,

James H. Cheek

James H. Cheek, III
Chairman, Committee on Federal Regulation of Securities

Benjamin M. Vandegrift

Benjamin M. Vandegrift
Chairman, Subcommittee on SEC Administration, Budget and Legislation

JHCIII/BMV:nm

Statement
of the
AMERICAN PUBLIC POWER ASSOCIATION
Submitted to the
SUBCOMMITTEE ON SECURITIES
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
on
SEC AUTHORIZATION

April 18, 1989

APPA supports increased authorization levels for the SEC to ensure that the Commission has adequate resources to meet its statutory responsibilities regarding the enforcement of the Public Utilities Holding Company Act. PUHCA was enacted in 1935 to protect the public against anti-competitive and fraudulent business practices of public utility holding companies. APPA believes that PUHCA continues to be an important consumer protection statute that structures and regulates the electric utility industry to protect ratepayers and consumers from monopoly abuses. Public power systems -- in particular the more than 900 systems that purchase power at wholesale from investor-owned utilities -- benefit from the protection afforded by the statute and support its vigorous enforcement.

Enforcement of PUHCA during the 1980s has not been vigorous. SEC Chairman David Ruder testified before this committee on April 19, 1989 that "due to budgetary constraints, the Commission's staff is having difficulty meeting its responsibilities on a timely basis under the Public Utility Holding Company Act of 1935." Moreover, Chairman Ruder warned that "without additional resources, the Commission's enforcement staff will be unable to maintain its current pace of enforcement actions..."

The current pace of enforcement, however, is sluggish at best. While limited budgets may have hampered enforcement action, it is clear that SEC antipathy toward PUHCA has played a significant role. In fact, the SEC has urged its repeal, which Congress has rejected time and time again. An agency that

encourages repeal of a statute might be expected to be less than vigorous in enforcing it. This is apparently the case with the SEC and PUHCA.

The SEC, according to an article in the May 28, 1987 edition of Public Utility Fortnightly, established "innovative structural approaches to avoid triggering jurisdiction under the Act..." Specifically, in some instances, utility holding company employees and staff would meet privately, and agree on a corporate structure that did not, in staff's view, implicate a specific provision of PUHCA. The staff would then send the utility a "no-action" letter, stating the staff's expectation that it would take no action to oppose the proposal. In such cases, the public has no opportunity to comment on whether the Act is implicated, and does not even learn about the utility transaction until afterwards, if at all.

In other cases, administration of PUHCA may be taking place largely free from public disclosure. For example, concerning utility proposals that require notice in the Federal Register and an opportunity to comment, utility officials commonly meet with SEC staff in advance of the notice to iron out the details in private. Then, when consumers protest the proposal pursuant to the Federal Register notice, the very same staff advises the Commission to reject the consumers' objectives.

Equally disturbing is the Commission's blanket approval of registered holding company acquisitions of alternative energy projects. Since 1983, the SEC has approved requests from nine registered holding companies to buy alternative energy projects. In each of these proceedings, the applicant revealed no information as to what projects would be acquired or what corporate structure would be used to acquire them. In each case, the Commission made no finding about "concentration of control" under Section 10(b)(1); no finding about "integration" under Section 10(c)(2); and, no finding about protection of the "public interest or the interest of consumers or investors," as expressly required by Section 10(b). Instead, the applicant requested and received advance, blanket approval.

In addition to acquisition of alternative energy projects, APPA is concerned about increasing utility diversification into non-utility businesses.

The legislative history of PUHCA clearly shows Congress' distaste for utility holding company forays into non-utility businesses. Senate Report No. 621, 74th Congress, at 30-31 states that "utility funds should be conserved for the development of the utility enterprise and not subjected to the hazards of speculative investments." Recent apparent diversification failures by Public Service of New Mexico, Pinnacle West Capital Corporation (parent company of Arizona Public Service), and El Paso Electric indicate the wisdom of PUHCA's authors. Nonetheless, the SEC recently proposed a diversification safe-harbor rule (Rule 17) that would allow an exempt intrastate holding company to invest up to 10 percent of its consolidated assets into diversified business without review by the SEC. Rule 17 appears to offer exempt holding companies carte blanche to diversify, to a significant extent, without SEC review. In light of recent apparent diversification failures, closer scrutiny of diversification efforts is needed to protect ratepayers from these more risky business investments.

Clearly, in its zeal to repeal, the SEC has been less than vigilant in its enforcement of PUHCA. Additional funds can provide the SEC the means to meet its statutory duties. However, Congress must ensure that the funds are used by the SEC to meet its statutory duty of protecting consumers and ratepayers from monopoly abuses. PUHCA was an important consumer protection statute when it was enacted in 1935, and remains so today.

Functional Regulation of Securities Markets (Senator Heinz)

Question:

The SEC has repeatedly stated its belief that it should have the authority to regulate certain securities activities of financial institutions. This was particularly true in the context of debate on the Proxmire Financial Modernization Act of 1988 which passed the Senate by a 94-2 vote last year. Given the dire resource problems at the SEC you have noted for us this morning, what assurances can you provide that the SEC would be able to assume such additional authority and execute it better than under the presently existing regulatory framework?

Response:

As we stated in our testimony, the Commission supports modification of the Glass-Steagall Act, provided that adequate safeguards are enacted to address investor protection concerns arising from increased bank securities activities. The Commission believes that investors will be adequately protected only if banks that engage in securities activities do so through separate subsidiaries or affiliates that are subject to the same regulations, enforced by the Commission, as are all other entities engaged in those activities. Moreover, as part of its plan to reorganize the savings and loan industry, the Administration has proposed that all securities issued by banks and thrifts to the investing public, with the exception of deposit instruments, be made subject to the registration requirements of the Securities Act, and that administration and enforcement of disclosure requirements with respect to such entities be transferred to the Commission. Both the Administration's plan with respect to the savings and loan industry, and modification of the Glass-Steagall Act with a provision for Commission regulatory authority, would necessitate additional Commission resources; however, centralization of securities regulation in a single regulator should provide overall savings to the government. In addition, much of the expense of broker-dealer regulation is borne by the securities self-regulatory organizations, which are funded by membership fees.

The Commission is actively pursuing efforts to increase its resources. For example, the Commission staff's study of the agency's staffing problems offered three options for increased funding, including two special funds that would provide monies for the Commission's operations, subject to Congressional oversight.

Role of Small Investor (Senator Heinz)

Question:

In a recent study, the Securities Industry Association disclosed that "inaccuracies" in its trading-volume data over the years have overstated the participation of individual investors on the New York Stock Exchange, and that last year small investors accounted for only 18.2% of total NYSE trading volume (less than half the percentage previously announced). Do you believe these figures to be accurate? If so, what does it say about the proper role of the small investor in today's marketplace? Given the changes that have occurred, and continue, might it be appropriate to focus less on the needs of the small investor and effectively relegate his/her participation to mutual funds?

Response:

As we understand its methodology, the SIA receives a report from the New York Stock Exchange ("NYSE") that identifies NYSE member firm proprietary trades and a report from the Depository Trust Company identifying institutional trades. The result, after discounting issuer stock repurchase plans, is the volume of trades executed for retail investors. The report is compiled on a monthly basis.

The NYSE currently does not itself independently calculate what percentage of its trading volume is accounted for by individual investors. In its 1989 Fact Book, however, the NYSE cites a survey conducted in 1985 revealing that approximately 47 million individual American investors own stock in public corporations directly or through a stock mutual fund. This figure has increased from 42.3 million individual investors in 1983. In addition, the incidence of share ownership in the total population, according to the NYSE survey, was 20.1%. In other words, one out of every five Americans today is an owner of corporate stock.

Although the SIA reports that individual investors reportedly accounted for 18% of the NYSE's trading volume in 1988, that figure must be measured against the nature of individual ownership of public corporations. In this regard, individual investors generally are not inclined to trade actively in their portfolios of equity securities. Instead, individual investors' general objective appears to be long-term investment, which usually is reflected in an invest and hold strategy rather than a short-term gain strategy that would involve more active trading. Also, that individual investors appear to be increasingly relying on financial intermediaries (e.g., investment companies and pension plans) to invest on their behalf in the corporate equity markets is not surprising, and is consistent with recent growth in the number and types of

financial intermediaries. As the financial marketplace becomes more complex and internationalized, the expertise of financial asset managers and the ability of large pooled assets to obtain more favorable commissions and execution services become more attractive to individual investors.

Regardless of the investment medium an individual investor chooses, the individual continues to play a critical role in the capital formation process. In this regard, it is not appropriate to relegate the role of the individual investor to participation in our equity market only through investment companies. Rather, the Commission's mandate is to ensure investor protection for all participants in the market. In this regard, the securities markets should be permitted to evolve and to seek participation from the broadest segments of the investing public. Indeed, individual investors, whether they buy shares in a public company directly through a broker or choose to invest in an equity mutual fund, are entitled to the investor protections of the securities laws.

Self-Regulatory Organization (SROs) (Senator Heinz)

Question:

We've been provided with a variety of statistical information showing Commission resources relative to the growth in the markets. Do you have available comparable information for SROs? Does the SEC, as a matter of course, keep track of SRO resources devoted to particular programmatic areas. Does the Commission require the SROs to increase member assessments in order to meet new market challenges? What staffing levels do you believe are appropriate for the SROs to enable them to effectively oversee industry?

Response:

The charts below provide some information concerning SRO resources and market growth. The charts use information concerning the New York Stock Exchange ("NYSE"), National Association of Securities Dealers ("NASD"), and Chicago Board Options Exchange ("CBOE").

Average Daily Volume

	1985	1986	1987	1988
NYSE*	109.16	141.02	188.93	161.46
NASD*	52.24	77.87	106.59	84.8
CBOE**	590,830	712,877	719,813	441,834

*millions of shares
**number of contracts

Number of Staff Persons (for Surveillance, Examinations, Enforcement, & Other Regulatory Programs)

	1985	1986	1987	1988	1989
NYSE	374	373	454	544	549
NASD	582	663	746	766	766
CBOE	98	100	98	111	106

As the charts indicate, the SROs have increased their staffs over the past five years partly in response to increased volume.

The Commission keeps track of SRO resources in several ways. First, every year the SROs file an annual amendment to their registration forms with the Commission. The amendment contains audited financial statements. These financials, along

with other information acquired from the SROs, enable the Commission to examine the funds devoted to regulatory programs. Second, the Division of Market Regulation conducts periodic inspections of the SROs' surveillance and compliance program. During these inspections the Division reviews the sufficiency of staffing devoted to these programs. Generally, the staffing levels of SROs are adequate to oversee the markets effectively. There have been instances in the past, however, where the Division concluded that staffing levels in a particular SRO program area were insufficient, and required the SRO to increase its resources in the deficient area.

The Commission does not establish member assessments for SROs, but leaves this decision to the business judgment of the SROs. Any change in member assessments, however, must be submitted to the Commission as a proposed rule change pursuant to Section 19 of the Securities Exchange Act of 1934. Rather than mandate member assessments, the Commission, as described above, monitors SRO resources devoted to regulatory programs to ensure that they are adequate to meet new market challenges.

Investor Complaints (Senator Heinz)

Question:

In your testimony (at page 5) you indicated that the Commission received 49,000 investor complaints during 1988, yet the Commission brought just 400 enforcement actions. What happened to the investor complaints? Did the remaining 48,600 not warrant further attention? To the extent that the Commission lacked the resources to pursue all 49,000 complaints, were they systematically referred to the NASD, the exchanges, and state securities administrators?

Response:

The 49,000 written or telephone complaints and inquiries, received by the Commission during FY 1988 1/ were analyzed, researched, and answered by headquarters and regional consumer affairs specialists. In processing many of the written complaints, staff requested a review and report of findings from the compliance or legal department of the appropriate broker-dealer, mutual fund, issuer, or other entity.

Many of the investor complaints received by the Commission relate to operational problems (such as order execution problems, delayed receipt of securities or funds, and errors in account statements), informational or communication problems, and other problems or concerns with individual investments. Both the referral of individual cases after screening and the analyses of overall trends in complaint types, complaints about industry practices, or complaints against specific entities provide valuable data for identifying oversight examinations and planning regulatory program activities. Information on specific complaints and periodic compilations of complaints are provided to self-regulatory organizations and state securities administrators.

Investor complaints and entity responses serve as an important source of information in the Commission's enforcement program. However, there is no direct relationship between the number of investor complaints and inquiries and the number of enforcement actions that the Commission brings each year. Investor complaints constitute only one source of Commission investigations; others include Commission examination and review programs, information obtained through other investigations, confidential sources, referrals by other organizations, press reports, voluntary disclosures and market surveillance activities. Commission decisions to open inquiries are a result

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1/ Of these complaints, more than 9,000 were telephone complaints lodged within the six weeks following the October 1987 market break.

of consideration of many factors, but must include consideration of resource requirements. Historically, between 15% and 25% of the enforcement investigations opened each year result, at least in part, from information obtained through investor complaints.

Risk Assessment for Holding Company Systems (Senator Heinz)

Question:

Legislation was recently introduced by Senators Dodd and Heinz, at the request of the Commission, which would, among other things, provide the Commission with the authority to obtain financial information of the affiliates of broker-dealers. Could you please identify the specific need for this legislation and indicate what use the Commission will make of the information?

It would seem that these reports may entail the collection of proprietary information. Will this information be publicly disclosed or will there be safeguards in place to protect its confidentiality? Why isn't the Commission able to obtain this information under present law? Are the SROs able to obtain this information -- if so, why aren't they?

Response:

The Commission and the SROs are not able to monitor broker-dealer holding companies and investment-related affiliates on a consolidated, world-wide basis adequately to determine the potential exposure to regulated broker-dealers of adverse occurrences or circumstances affecting the broker-dealers' related entities.

The purpose of the "Risk Assessment" section of S. 648 is to enable the SEC to monitor effectively affiliate and holding company activities so that it may obtain "early warning" of any problems in these entities that would threaten the financial well-being of registered broker-dealers. The SEC would thus be in a better position to consult with SROs and domestic and foreign government agencies in order to plan possible responsive action and avoid further endangering the financial integrity of the securities industry.

In the past decade, the unprecedented growth and change in the financial markets (including, among other things, the increased internationalization of securities markets and the growing tendency of firms to take proprietary risk positions in dealing with their customers) has resulted in the need for broker-dealers to accumulate large capital bases. To obtain the levels of capital necessary to compete on a global basis, even the largest firms have had to access the public equity markets, increase their leverage, or merge or affiliate with other entities. Many firms have created holding company structures to facilitate their world-wide growth. In this regard, the absence of regulatory accountability for broker-dealer affiliates and holding companies has allowed registered firms to avoid SEC regulation by moving many potentially risky activities (which would entail significant capital charges if conducted in the

broker-dealer) such as interest rate swaps, bridge loans and foreign currency transactions out of the broker-dealer.

The expansion of firms' activities domestically and abroad, the change in their structures, and their transacting of significant portions of their total investment-related activities -- including potentially risky proprietary business -- outside of the broker-dealer has left the SEC in a position in which it is increasingly difficult to evaluate the operations and financial well-being of securities firms without a thorough understanding of their over-all-corporate structures.

Moreover, financial difficulties at the holding company or affiliated entities could impact the ability of the broker-dealer subsidiary to obtain sufficient short-term financing to meet its operating and settlement obligations. The ability of a U.S. broker-dealer to continue operations if a major affiliate closed its doors is problematic at best. Given these concerns, it simply makes no sense for the Commission to be operating without concrete information regarding at least the other major unregulated financial operations carried out in the holding company. Without the ability to obtain this information upon request, we are forced to guess which firms may be most vulnerable in a period of high stock market, interest rate, or exchange rate volatility. Moreover, if contra party or financial institution concerns arise over the stability of other parts of the holding company, the Commission lacks the information to adequately address these concerns.

Information received from broker-dealer's affiliates and holding companies would entail the collection of proprietary information. The Commission staff envisions that information received from affiliates and holding companies would be deemed confidential, as are routine financial reports which are received pursuant to the Commission's reporting requirements. See Rule 17a-5(e)(3).

Tender Offer Reform (Senator Heinz)

Question:

One of the principal criticisms of the tender offer process is that raiders are easily able to put companies "in play" by announcing a tender offer and filing the appropriate schedules with the SEC, even though, at best, they have a highly conditional offer and questionable intent to proceed with a transaction. Wouldn't one way to limit this activity be to require that bidders have firm financing in place at the outset of the offer (bank commitments in hand, for example)? Does the Commission presently have the authority to require this or would legislation be necessary?

Response:

The Commission has not supported reforms that seek to impose a requirement that tender offers be financed prior to commencement. 1/ While a tender offer could be used to put a company in play or to receive greenmail rather than to acquire the subject company, there is little evidence that this is a real problem. Such evidence would be necessary to justify precluding the legitimate use of financing conditions in tender offers.

Rather than mandate that firm financing be in place prior to the commencement of the offer, the Commission's rules require disclosure concerning the source of financing, including the absence of such arrangements, and require the disclosure of any plans to obtain the financing. 2/ On the basis of that disclosure, the market evaluates the nature and extent of the bidder's financing in assessing the probability that an announced takeover attempt will be consummated. When an offer is commenced without financing in place, and financing is later obtained, that fact will constitute a material change in the information previously provided to shareholders and obligate the bidder to amend its tender offer materials, disseminate the information to shareholders, and extend the offering period if necessary to

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1/ Statement of Charles C. Cox, Acting Chairman of the Securities and Exchange Commission, Before the Senate Committee on Banking, Housing and Urban Affairs, Concerning Corporate Takeover Legislation, S. Hrg. 183, 100th Cong., 1st Sess. at 101 (June 23, 1987).

2/ See e.g., IU International Corp. v. NX Acquisition Corp., 840 F.2d 220, 224-225 (4th Cir.), aff'd on rehearing en banc, 840 F.2d 229 (1988); Newmont Mining Corp. v. Pickens, 831 F.2d 1448, 1453 (9th Cir. 1987); Brief of the SEC, Amicus Curiae, IU International Corp., 840 F.2d 220; Brief of the SEC, Amicus Curiae, Newmont Mining Corp., 831 F.2d 1448.

provide shareholders with adequate time to consider the information. 3/

A firm financing requirement may not be practicable in light of the significant defensive measures allowed target companies under state law that can delay an offer for a significant period of time. The delay and uncertainties caused by these measures could make financing commitments difficult to obtain or prohibitively expensive. Such a requirement could therefore favor the subject company over the bidder, and would be at odds with the congressional intent in regulating takeovers to avoid "tipping the balance of regulation either in favor of management or in favor of the person making the takeover bid." 4/

The Commission would have the authority to adopt a firm financing requirement if the Commission found such a requirement to be necessary to prevent fraudulent conduct. Pursuant to Section 14(e) of the Williams Act, the Commission has authority to prescribe means reasonably designed to prevent fraudulent, deceptive or manipulative acts or practices in tender offers. This authority allows the Commission to prohibit those actions which in and of themselves are not fraudulent, but in the context of tender offers may be used to facilitate fraud. 5/

3/ See Securities Exchange Act Release No. 24296 (April 3, 1987); Securities Exchange Act Release No. 23421 (July 29, 1986).

4/ House Comm. on Interstate and Foreign Commerce, Disclosure of Corporate Equity Ownership, H.R. Rep. No. 1711, 90th Cong. 2nd Sess. 4 (1968).

5/ See Schreiber v. Burlington Northern, Inc., 472 U.S. 1, 11 n.11 (1985).

LBOs (Senator Heinz)

Question:

The Commission's Rule 13e-3, to the extent that it is even applicable to a leverage buyout transaction, requires that a party taking a company private express its view as to the "fairness" of the transaction to shareholders. Is fairness an appropriate criteria? Wouldn't a more objective measure be more useful to a shareholder trying analyze the merits of an offer for his shares?

Has the Commission ever brought a fraud action against an investment banker for rendering a "fairness" opinion where the actual sale price turns out to be much higher than that opined to as fair?

Response:

Rule 13e-3 is partly intended to make information available to shareholders to allow them to exercise their state law rights and to enforce state law duties of directors. The Delaware Supreme Court has stated that when directors stand on both sides of a transaction, "they are required to demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain." 1/ In such cases, directors of Delaware corporations have the burden of establishing the transaction's "entire fairness" that is, the existence of both "fair dealing" and "fair price." 2/

A fairness assessment, however, does not necessarily assure that the price offered is the best price. There are examples of prices declared to be fair to shareholders that are quickly topped by 30-40 percent by a number of unsolicited bids. The difficulty lies in the inexact nature of the fairness assessment. The concept of fairness under state law has been viewed, historically, as a range of reasonable values. 3/ For that reason, it may be difficult to bring a fraud action requiring scienter against an investment banker based upon a fairness opinion. The Commission, instead, has dealt with this issue primarily by requiring disclosure regarding the basis for the fairness assessment. For example, disclosure is required of

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1/ Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983).

2/ Id. at 710-711.

3/ See Chazen, Friedman & Feurstein, Premiums and Liquidation Values: Their Effects on Fairness of an Acquisition," Inst. Sec. Reg. 147 (1980); See generally Note, Investment Bankers' Fairness Opinions in Corporate Control Transactions, 96 Yale L.J. 119 (1986).

the techniques employed in evaluating fairness and the actual values for the company arrived at through each analysis.

In recent years, the Delaware courts have addressed certain concerns with the fairness standard. Recent case law has emphasized the directors' responsibility to seek the best price reasonably available to shareholders when the corporation is to be sold, as in the case of a management buyout. 4/ This development increases shareholder protection by introducing auction concepts into pricing decisions.

4/ See, e.g., Mills Acquisition Co. v. MacMillan, Nos. 415 & 416, Del. Sup. Ct. (May 3, 1989); Revlon, Inc. v. MacAndrews & Forbes Holdings, Inc., 506 A.2d 173, 182 (Del. 1986).

LBOs (cont'd) (Senator Heinz)

Question:

Chairman Ruder, you have studied the leveraged or management buyout phenomenon and have testified on this issue in a number of forums. Something that troubles me is the contention of buyout proponents that the only way to run a company efficiently is for managers to own the company and/or the owners to be on the Board of Directors. What, in your view, does this auger for the future of publicly-held companies? Are publicly held American companies doomed to failure in the increasingly competitive global marketplace unless they change their ownership structure?

Response:

Over the last year, leveraged buyouts have received the intense scrutiny of Congress, academics, participants in these transactions, and federal regulators, including the Commission's staff. Many studies are ongoing, but preliminary results do not support the conclusion that LBO's are, on balance, detrimental. While there are problems that need to be addressed, in many cases leveraged buyouts appear to have had significant beneficial effects in terms of returns to shareholders, and in terms of corporate efficiency and profitability.

The problems inherent in the separation of management from ownership have been recognized for a long time. 1/ To the extent that LBOs result in the reintegration of corporate ownership and management, the incentives for efficient and profitable corporate management are increased. Corporate managers who have a direct and significant financial stake in the success or failure of the business are likely to be better managers.

Some attribute the success of the LBO movement to the current tax law provisions that favor acquisition financing through the increase of debt and the reduction of dividend payments. The double taxation of dividends gives corporations the incentive to favor debt over equity as a source of financing. However, debt may not always be a viable financing alternative for a company, depending upon its balance sheet, the stage in its corporate development, or other circumstances. Public offerings of equity securities will continue to provide corporations with an attractive source of financing to expand operations or repay expensive debt. Equity also affords management greater flexibility than debt. Thus, there will always be a need for large infusions of equity capital from the public, and corporations will need to produce an efficient product or service

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1/ A. Berle & G. Means, The Modern Corporation and Private Property (1932).

in order to attract investment capital. Accordingly, significant public ownership, and efficient and globally competitive corporations, are expected to thrive well into the future.

Trust Indenture (Senator Heinz)

Question:

With respect to the Commission's proposal to revise the Trust Indenture Act of 1939 (the "Act"), there are those who subscribe to these views, that by allowing an institution to serve as indenture trustee, even though it has a substantive business relationship with the issuer, creates an untenable conflict of interest for the trustee -- or at least an uncomfortable appearance of conflict. How would you respond?

Response:

The Act currently permits an indenture trustee to have a creditor relationship with an obligor under the indenture. No substantive business relationship could create clearer potential conflict than that between the interests of a trustee-creditor and the indenture security holders. Since most institutional trustees are commercial banks, a creditor relationship with the obligor is a normal occurrence. Nonetheless, a trustee that is also a creditor of the obligor may hold interests adverse to those of holders under the indenture. Consequently, the Commission's proposed legislation would make a creditor relationship a conflict requiring disqualification when a default occurs.

At the time of default, institutional trustees that are creditors routinely resign their offices, even though resignation is not now compelled by the Act. They are concerned about a possible appearance that they are no longer able to represent fairly both the claims of security holders under the indenture and their own claims. The approach followed by institutional trustees in successfully dealing with the creditor relationship for almost fifty years recognizes that the statutorily required duties of a trustee prior to default are fairly ministerial. The trustee must preserve lists of security holders, act as a medium for communications between security holders, and receive reports and certificates from the obligor. While these functions are important, they do not require the exercise of discretion. In the absence of a default, there is no reason for a trustee to withhold these services even if a conflict exists. In contrast, when a default arises under an indenture, the trustee becomes an active advocate of security holders' interests and it is at this point that an institutional trustee with a creditor conflict generally resigns.

The Commission's proposed legislation recognizes that the Act does not impose real duties of guardianship on indenture trustees prior to default. Accordingly, like the voluntary approach to dealing with creditor relationships, the revised provisions would not require a trustee with a statutory conflict to resign until a default arises.

Insider Trading Definition (Senator Heinz)

Question:

As you know, we last year passed the Insider Trading and Securities Fraud Enforcement Act of 1988 which created significantly enhanced penalties for the crime of insider trading. But as you also know, we did not define the crime of insider trading. That has been left to the courts to develop on a case by case basis. I'm well aware that for the vast majority of plain vanilla insider trading cases, the lack of a statutory definition is not a problem -- the misconduct is well understood to be a crime. Nonetheless, there remain a number of gray areas in the law. Mr. Ruder, should we now attempt to legislatively define insider trading? The Commission has worked to develop a definition with an ad hoc group of leading securities lawyers. Have those efforts yielded a workable framework from which we can proceed? One that can avoid the argument that a definition would only provide a roadmap for circumvention?

Response:

Since the Supreme Court decision in Carpenter v. United States, 484 U.S. 19 (1987), in which the Court split 4-4 on the issue of whether the defendants had violated Section 10(b) of the Exchange Act and Rule 10b-5 in connection with The Wall Street Journal insider trading scheme, each district court that has considered the issue has concluded that the "misappropriation" theory of insider trading liability is a valid basis for finding a violation of Section 10(b). See, e.g., SEC v. Clark, Civ. Act. No. 87-711Z (W.D. Wash.), Lit. Rel. No. 12111 (May 31, 1989); United States v. Elliott, 88 Cr. 645 (N.D. Ill. jury verdict of guilty returned on June 23, 1989); SEC v. Musella, 678 F. Supp. 1060 (S.D.N.Y. 1988). The Supreme Court has also declined to review several cases in which misappropriation has been applied and thereafter challenged. See, e.g., SEC v. Tome, 638 F. Supp. 596 (S.D.N.Y. 1986), aff'd, 833 F.2d 1086 (2d Cir. 1987), cert. denied, 108 S. Ct. 1751 (1988); United States v. Grossman, 843 F.2d 78 (2d Cir. 1988), cert. denied, 109 S. Ct. 864 (1989). In view of the uniform development of the case law, as well as Congressional recognition of the appropriateness of the misappropriation theory and concern with the possible effects of an insider trading definition, H.R. Rep. No. 910, 100th Cong, 2d Sess. (1988), there does not appear to be an urgent need for legislative action in this area. Moreover, one perceived advantage of an insider trading definition, that it could provide an express private right of action in insider trading cases, is now unnecessary because such a provision was included in the Insider Trading and Securities Fraud Enforcement Act of 1988. However, should Congress wish to take up again the issue of a definition, the previous efforts of the Commission and the ad hoc committee should provide a useful basis from which to proceed.

As the Subcommittee will recall, the Commission submitted a proposed definition of insider trading to the Subcommittee on August 3, 1987, and the Subcommittee held hearings on this proposal on August 7, 1987. At the hearing, and thereafter by letter, the Subcommittee requested that the Commission assist in the development of a consensus proposal for legislation defining insider trading. In response to that request, members of the Commission's staff met with representatives of the ad hoc committee to discuss a potential compromise. Following these meetings, and as a result of further Commission consideration of the definition, the Commission, acting by a majority, determined that it could support legislation that differs in certain respects from the Commission's original proposal and includes certain provisions adopted from the ad hoc committee's proposal, provided that certain interpretive positions are clearly set forth in the legislative history accompanying the bill. On November 18, 1987, the Commission submitted to the Subcommittee its revised proposal for compromise legislation, and on February 8, 1988, the Commission transmitted proposed language for inclusion in the committee report for the proposed legislation. With the exception of one substantive area in which it was not possible to reach agreement, and certain differences as to language believed to be technical in nature, it was our understanding at the time that we submitted the revised proposal that it also would be acceptable to the ad hoc committee. Consequently, the proposed definition would provide a workable framework for legislation.

Rule 144A (Senator Heinz)

Question:

The Commission has proposed a rule, Rule 144A, which has the laudable purpose of increasing the liquidity of the private placement market and making U.S. capital markets more attractive to foreign issuers. However, several commentators have expressed concern that the rule as proposed could result in the development of dual trading markets in the same securities, with the practical effect that individuals will be foreclosed from trading in the larger, more liquid private placement marketplace. Do you believe this is a legitimate concern?

Commentators have also expressed concern about disclosure in the private placement market. One of the principal trading attractions to issuers, especially foreign ones, to privately placing securities is that they can avoid registration and disclosure requirements. In view of the substantial criticisms of the fairness of securities markets, should we, at this time, be encouraging securities issuances without high levels of disclosure?

Response:

When it initially proposed Rule 144A, the Commission noted that it did not expect that Rule 144A would give rise to any significant volume of private transactions in classes of publicly-traded securities. Notwithstanding the potential of the Rule to increase efficiency in the private resale market and the ability of issuers to avoid costs and delays associated with registration, information currently available to the Commission suggests that it would not be financially advantageous for companies generally to sell securities in a market that was limited in its depth and liquidity compared to an existing public market for the same securities. Public companies reportedly tend to issue equity securities privately only in special circumstances, such as in transactions involving debt securities with an equity component, a leveraged buy-out, a joint venture, or a restructuring. Moreover, securities in the institutional market would be likely to flow into the public market when the holding period requirement of Rule 144 was satisfied. Thus, it appears unlikely that the institutional market for such securities would grow larger than the public market for the same class of securities over time. Nevertheless, the Commission requested comment on the likelihood that side-by-side markets would evolve and whether steps should be taken to preclude the development of such markets.

Commenters were divided regarding the likelihood that side-by-side markets would develop. Several commenters urged the Commission to take steps to preclude such markets from developing, although they did not explain why they believed

substantial institutional markets would develop in publicly traded equities (which presumably would still trade at a discount to the same securities in the public market). The Commission remains of the opinion that development of significant side-by-side markets is unlikely. Nonetheless, the Rule, as reproposed by the Commission on July 11, 1989, would not extend to transactions in securities of a class that is listed on a U.S. securities exchange or quoted in NASDAQ.

Proposed Rule 144A addresses the issue of resale of unregistered securities. The original offering of securities under Section 4(2) of the Securities Act or other exemptive provisions to the specified institutions historically has not been subject to mandatory disclosure requirements. Proposed Rule 144A would not change this result. It should be noted that most U.S. companies whose securities are likely to be traded in reliance on Rule 144A would be subject to the reporting provisions of the Securities Exchange Act; reporting is required where the issuer has 500 or more holders of a class of equity securities and at least $5 million of assets. The public reports provide the same information about the issuer as that required in a registration statement.

Foreign private issuers that do not undertake public offerings in the United States, and whose equity securities are not traded on a U.S. exchange or quoted in NASDAQ, are exempted from the reporting requirements of the Exchange Act by Rule 12g3-2(b). Under that rule, foreign issuers that have more than 300 U.S. shareholders and more than $5 million in assets are only required to provide to the Commission copies of home country filings. Approximately 1450 foreign issuers' securities are currently traded in the United States under this exemption. These securities may be sold to any investor, individuals as well as institutions. Proposed Rule 144A, on the other hand, would apply only to the resale of securities to eligible institutions.

The reproposal issued by the Commission on July 11 addresses the potential of Rule 144A to increase substantially the amount of foreign securities being sold into the retail market, without Exchange Act reporting obligations being incurred, in two ways. The proposed amendments to reduce the holding period under Rule 144 would not be available for securities of non-reporting foreign private issuers. Resales of such securities into the U.S. retail market thus could be made only after the investor had held the security for at least two years. In addition, as reproposed, Rule 144A would include resale restrictions for transactions involving securities of non-reporting foreign private issuers traded in both a U.S. and a foreign market. These revisions, together with the offshore resale provisions of Rule 906 under proposed Regulation S, should minimize the potential for proposed Rule 144A to increase significantly the sale of foreign securities in the United States to investors other than institutions eligible to purchase under Rule 144A.

Some have suggested that the principle of caveat emptor applies to purchases of securities in the private placement market. This assertion is entirely incorrect. Securities Act Section 12(2) provides a purchaser of a security with an express civil remedy against the seller for misleading statements or omissions negligently made by the seller. Section 12(2) applies not only to public offerings of securities, but to private placements as well. The antifraud provisions of the Securities Act and Exchange Act, including Rule 10b-5, also apply in the context of private placements. Caveat emptor is simply not a principle that has a place in the federal securities laws, which impose upon a seller of securities a duty of truthfulness, whether or not the transaction is exempt from the Securities Act registration requirements.

Some commenters on Rule 144A raised concerns regarding the need for a minimum level of disclosure about the issuer of the securities to be resold under the Rule. In response to those concerns, as reproposed by the Commission on July 11, the revised rule would require that, where the issuer is neither filing periodic reports with the Commission under the Exchange Act nor furnishing home country filings to the Commission under Rule 12g3-2(b), the seller of the securities provide the buyer upon request with specified basic information concerning the business of the issuer and its financial statements.

Rule 144A should provide increased liquidity in the secondary market for privately placed securities. The potential increase in liquidity could significantly lower the discount commonly associated with private placements, which could in turn attract an increasing number of issuers, including foreign issuers, into the U.S. private placement market. Where U.S. investors are compelled to go offshore to fulfill their demonstrated desire to diversify their portfolios on a global basis, they may be forced to purchase securities in markets where the principle of caveat emptor may indeed apply. As foreign issuers enter the U.S. markets and subject themselves to potential liability under the federal securities laws, even in the case of exempt offerings, fewer U.S. investors will be compelled to purchase securities without the benefit of the protections of those laws.

SEC Funding (Senator Heinz)

Question:

One of the principal arguments you advance in support of additional financial resources or to become a self-funding agency is that the SEC generates substantially more revenues than it actually spends. In fact, in 1988 the Commission collected $249 million in fee revenue while it spent just $135 million, a difference of $114 million, which went to the Treasury's coffers. I note that the Commission is requesting an authorization of $238.1 million by 1992, which is not significantly less than the current fee base. Do you anticipate commensurate increases in the fee base? If not, isn't it likely that by the mid-1990s, if the SEC's budget would continue to increase at the rate you propose, the SEC would not be financially self-sufficient?

Response:

Throughout the 15 year period between 1973 and 1988, the value of SEC fee collections has maintained an average annual growth rate of 20 percent. SEC appropriations have experienced a 12 percent average annual growth rate over the same 15 year period. Similarly, the Commission's 1992 authorization request represents a 15 percent increase per year from 1988. Should the growth rate of fee collections decline, then it is possible that SEC revenue in 1992 might be less than the proposed authorization level. In this event, adjustment to the fee schedule might be required.

SEC Personnel Policies (Senator Heinz)

Question:

Mr. Chairman, in your budget authorization request and in the Self-Funding Study you make a compelling case for paying higher salaries to obtain and retain competent staff. I would note that in our recent discussion of the thrift crisis, competent well-paid staff was considered vital to proper regulatory oversight. In fact, we included language in S. 413 which specifically exempted bank and thrift regulatory personnel from government pay caps. Do you believe we should do the same to the SEC? Until such time as increased fund becomes available, are there any other steps the SEC is taking, or should be taking, to encourage younger staff to stay at the Commission beyond 2-3 years?

In this regard, it is my understanding that staff professionals desiring to gain a broader exposure to the Commission's program areas are discouraged from moving from one division in the Commission to another. For example, if an attorney in the Division of Enforcement wants to obtain experience with the disclosure regulations, in the Division of Corporation Finance, and a spot is open, is he or she able to do so (and vice versa)?

Response:

The SEC should be exempted from the government pay caps. Such an exemption is useful, of course, only if additional funding is available for the increased expenditures. Within the existing compensation and reward systems, the SEC utilizes a variety of means to encourage staff retention including:

- maximum use of awards;
- broadening promotion possibilities within the Title 5 classification constraints;
- vigorous recruitment efforts at law schools, colleges, and job fairs to attract entry level professionals;
- vigorous recruitment of experienced attorneys and accountants who see the public sector as an opportunity to have a professional impact as well as for developing a better balance between work and family;
- hiring at advanced grades or salaries where appropriate and justified;
- requesting 3 year commitments from professional staff;

- promoting the challenges of high responsibility on significant matters and work for the public good in agency recruitment efforts;

- initiation of quality of work life programs such as flexible work schedules; and

- increased salaries for staff in hard to fill occupations or high cost areas.

The internal movement of staff within the SEC is not discouraged.

Staff Turnover (Senator Heinz)

Question:

In your testimony and budget authorization submission, you cite as a substantial problem the high turnover rate in the professional staff ranks at the Commission. Yet, to a question at the Commission's last budget authorization hearing, the written response was "although the Commission's turnover rate has been higher historically than the government average, the Commission has viewed high turnover as desirable for several reasons."

Has the Commission's thinking on this subject changed in the past two years? What in particular has given rise to the changed viewpoint.

Response:

As stated in the staff's Special Funding Study, turnover at the Commission is accelerating at an alarming rate. In recent years, approximately two-thirds of all attorneys left the Commission in fewer than four years and fully half left in fewer than three years. A decade ago the average tenure for a staff attorney was four to five years. The difference between three and four or five years of service is dramatic, since the effectiveness of the staff attorneys increases significantly after three years of service. In the past, the decreasing tenure of staff attorneys was tolerable and, in certain respects, even desirable. Today the shortened period of service has become a major concern. Excessive turnover causes managers to spend a high proportion of their time recruiting and training new staff, and means that much of the Commission's work is done by relatively inexperienced staff. The staff's Special Funding Study offered several recommendations to reduce staff turnover.

Personnel Policies (Senator Heinz)

Question:

Could you describe in some detail the Commission's training and continuing education programs for professional staff? Law firms often send their younger attorneys to professional seminars and conferences so they can be exposed to the latest developments in their areas of responsibility. Does the Commission do the same for its staff attorneys on a systematic basis?

Response:

Each Division and Office is surveyed annually to determine staff training needs. Programs are then developed to address the needs of target groups. Throughout the year, as individual training needs arise, training is arranged in accordance with agency priorities, availability of funds and the extent to which training is needed for the employee to adequately perform the job.

The Commission provides extensive in-service training sessions on topics pertinent to each program area for both headquarters and regional office professionals. Employees are also apprised of new developments in their areas of responsibility through memoranda and staff meetings.

Each year approximately 550 to 700 Commission staff members attend outside conferences and professional development seminars. During the first nine months of FY '89, there have been 520 instances of outside professional development training. While the Commission has expended $35,000 for outside professional development conferences and seminars, the vast majority of attendees have been in gratis or reduced rate slots as a result of Commission speakers' participation in those programs and other cooperative agreements with legal education institutes. The savings from gratis or reduced rates have been over $173,000 thus far in FY '89. Therefore, the Commission has provided the equivalent of $209,000 in professional development training for the first nine months of this fiscal year.

Securities Law Study (Senator Heinz)

Question:

A provision of the Insider Trading and Securities Fraud Enforcement Act, which passed last year, required the SEC to undertake a comprehensive study of the securities markets, along the lines of the 1963 Cohen study. The study was contingent upon the SEC receiving a separate appropriation of $5 million. In your appearances before the House and Senate appropriations committees, have you requested the $5 million appropriation for the study as contemplated by last year's bill? If not, why not? Do you believe the markets have sufficiently changed in the intervening years to warrant taking a new, broad look at the capital markets?

Response:

The markets have changed dramatically since 1963. For example, the world's securities markets have become increasingly automated and interlinked and the volume of capital moving across national borders has grown. A new and broad look at regulations of national and international capital markets is fully warranted. Moreover, the number of novel and complex securities transactions subject to Commission review has risen dramatically since 1963. Section 7 of the Insider Trading and Securities Fraud Enforcement Act of 1988 thus called on the Commission to conduct a "study and investigation of the adequacy of the Federal securities laws and rules and regulations thereunder for the protection of the public interest and the interests of investors." Conduct of the study is contingent upon the appropriation of $5 million, which was authorized by the Act. Despite the importance of such a study, the Commission's 1990 budget request did not include a request for appropriation. Given the dramatic needs of the Commission to conduct its enforcement and regulatory responsibilities, utilizing funds in a regular budget for a study did not seem appropriate in an environment calling for budgetary restraint.

International Securities Enforcement (Senator Heinz)

Question:

Last year, the House Committee on Government Operations issued a report (H. Rep. 100-1065) that was very critical of the SEC's international securities enforcement program. Now I don't subscribe to most of that Committee's conclusions or recommendations, but they did raise some valid concerns. In particular, the Committee found that the Commission rarely pursues trades originating from the countries with which the U.S. does not have bilateral information sharing agreements and that SROs are often slow to make enforcement referrals to the SEC. In fact, the 614 market surveillance reports sent by the SROs during 1986 and 1987 were, on average, over 8 months old. Could you please tell us what progress the Commission has made in responding to these criticisms?

Response:

The Commission is committed to improving its ability to obtain information from abroad regarding suspect transactions. In this regard, the Commission has signed or initiated discussions regarding the establishment of information sharing agreements with the relevant regulators in many of the largest securities markets. Moreover, the Commission is not reluctant to pursue cases involving trading which emanates from markets with which it does not have agreements. For example, last year the Commission initiated its largest insider trading case involving trading from Hong Kong, a country with which it has no information sharing agreement. SEC v. Wang and Lee, 88 Civ. 4461 (RO) (S.D.N.Y. 1988). In addition, the Commission regularly seeks investigative evidence from countries with which it has no such agreements.

A number of actions by the Commission and the SROs are relevant to the criticisms contained in the report of the House Committee on Government Operations regarding SRO enforcement referrals to the Commission:

- The SROs have made substantial progress in reducing referral times. During the last six months of fiscal 1988 the average median referral time was 6.6 months, as compared to 9.4 months during the first half of 1988, a decrease of approximately 30%. The arithmetic average referral time was reduced from over 8 months to 6 months. During the first six months of fiscal 1989, these times were reduced further: the average median and arithmetic average referral times were 4.5 months and 5.6 months, respectively.

- Several of the larger SROs have initiated procedures which will provide for summary fines for member firms

that fail to comply with requests for information in a timely manner.

- SROs now require that member firms be capable of submitting basic trading information in an automated format. This significantly reduces the need for manual analysis of the large volume of data received from brokerage firms. It also increases the utility of other systems which automatically compare trading information received with existing data bases to determine whether potential or actual connections can be made among market participants.

- Requests to firms for information are now made via FAX transmission.

In addition to the foregoing, the Commission's staff has been working closely with the SROs to reduce the number of older matters that are still under inquiry. Such efforts should reduce the case inventory, allow resources to be allocated to more recent matters, and provide SRO staff with a better perspective on the importance of various types of cases and fact patterns which are of interest to the Commission's staff.

Public Utility Holding Company Act (Senator Graham)

Question:

What has prompted the SEC to propose rule 17 under the Public Utility Holding Company Act of 1935?

Response:

Section 3(a) of the Public Utility Holding Company Act generally requires the Commission to exempt predominantly intrastate holding companies from any provision or provisions of the Act, unless the Commission finds the exemption detrimental to the public interest or the interest of investors or consumers. Recently, substantial diversification activities by some exempt intrastate holding companies have raised questions concerning whether these companies continue to be entitled to their exemptions from the Act.

Proposed Rule 17 is intended to clarify the appropriate standards for permitting diversification activities of exempt intrastate holding companies. The proposed Rule recognizes the Act's policy that extensive diversification is not desirable for exempt intrastate holding companies unless that diversification occurs under state supervision.

Public Utility Holding Company Act (cont'd) (Senator Graham)

Question:

In its June 1982 statement to Congress, the SEC said it would not raise the issue of non-utility investments by exempt holding companies, unless the financial integrity of the utility system were threatened or the company was no longer primarily in the utility business. Does the Commission view either of these sets of circumstances to exist with respect to any particular company or companies?

Response:

Some companies are becoming so diversified that in some cases non-utility businesses unrelated to utility operations are becoming as important as utility and utility-related operations. If large enough, such diversification may threaten the financial integrity of an exempt holding company. At least one company has suffered serious financial reverses as a result of non-utility investments. In any event, the Act does not contemplate that actual harm to investors, consumers, and the public interest occur before the Commission can deny or revoke exempt holding company status.

Public Utility Holding Company Act (cont'd) (Senator Graham)

Question:

Is the Commission concerned about utility diversification in principle? What is the basis for its concerns?

Response:

Section 1(b)(4) of the Public Utility Holding Company Act declares that the national public interest and the interest of investors and consumers may be adversely affected "when the growth and extension of holding companies bears no relation to economy of management and operation or the integration and coordination of related operating properties." The Commission also believes that when an exempt public-utility holding company engages in non-utility activities, there is a potential for detriment to protected interests. Should non-utility investments prove unsuccessful, the investment caliber of the exempt holding company's securities may decline, the costs of raising additional capital for contribution to utility affiliates may rise, and the rates charged to consumers, which support the securities, may become higher than might otherwise be necessary. Other potential detriments that could result from non-utility diversification include the transfer of expertise and management acumen created within a utility, purchases from non-utility affiliates at above market prices, and the potential for decreased reliability of utility service.

Conversely, cautious, prudent diversification by holding companies into areas unrelated to their core business could translate into improved earnings prospects for investors and could be potentially beneficial to consumers by reducing the utility's cost of capital and improving its access to the capital markets.

Public Utility Holding Company Act (cont'd) (Senator Graham)

Question:

Given the more favorable treatment accorded SEC ordered divestitures under Section 1081 of the Internal Revenue Code, exempt holding companies not coming within a Rule 17 safe harbor would have an incentive to avoid voluntary divestiture and apply for an exemption. Is the Commission prepared to handle the resulting applications for exemptions in a timely fashion?

Response:

As discussed in the Commission's testimony, due to budgetary constraints the Commission's staff is having difficulty meeting its responsibilities on a timely basis under the Public Utility Holding Company Act. In its review of applications for exemptive relief, the staff has been required to analyze complex issues, such as the creation of holding companies in order to facilitate diversification, and increased diversification by registered holding companies into nontraditional utility areas. Recently, many of the largest public utility holding company systems in the United States have expressed their desire for prompter response by the staff to exemptive and rulemaking requests. Without increased appropriations, however, it will not be possible to eliminate significant existing backlogs in exemptive and rulemaking requests. Any increase in applications would create an additional resource burden on the staff.

Public Utility Holding Company Act (cont'd)

Question:

We have been advised that, since 1983, the SEC has approved requests from nine registered holding companies to buy alternative energy projects. We are told that, in each of these proceedings, the applicant holding company revealed no information as to what projects would be acquired or what corporate structure would be used to acquire them. Instead, the applicant requested and received advance, blanket approval to use virtually any corporate structure. Will additional staff allow the SEC to review such applications on a case-by-case basis, instead of by blanket exemption?

Response:

Additional staff would expedite Commission review, but would not change the nature of that review; where "blanket approvals" have been granted, they have been based on the nature of the application, not lack of staff. Prior approvals of acquisitions of interests in such projects were limited to a specific time period and by the amount of related financing approved. The approach allowed registrants to compete on a timely basis with other potential, non-holding company bidders. Moreover, such blanket approvals further the Congressional purpose in adopting the Public Utility Regulatory Policies Act of 1978 and the legislation designed to facilitate registered holding company investment in cogeneration projects.

Public Utility Holding Company Act (cont'd)

Question:

We have received complaints that some administration of the Public Utility Holding Company Act may be taking place largely free from public disclosure. With respect to utility proposals which require notice in the Federal Register and an opportunity for comment, utility officials commonly meet with the SEC staff in advance of the notice to iron out details in private. We have been told that when consumers protest the proposal pursuant to the Federal Register notice, the same staff advises the Commission to reject the consumer's concerns. Does this practice occur? If so, please explain the reasons and advise us whether it will continue.

Response:

The Commission staff is authorized by the Commission's rules to meet with an applicant to respond to the applicant's inquiries concerning the staff's interpretations of the Act, the permissibility of contemplated transactions under the Act, issues that may be raised if proposed filings are made with the Commission, information needed by the staff for its review and for a complete record, scheduling problems, and other related matters. See 17 C.F.R. 202.2 and 203... Applicants for orders under the Act, like applicants under the other statutes administered by the Commission, frequently request such meetings, and, to the extent possible, the staff accommodates these requests. These meetings serve a useful purpose by avoiding the need for applicants to file amended applications, by alerting the staff and applicants to significant issues in applications, and by narrowing the issues to be addressed in the application and any subsequent hearing.

All interested parties have an opportunity to make comments or request a hearing on an application after notice of its filing is published in the Federal Register. The staff's response to the applicant's inquiries prior to public notice does not necessarily mean that the staff will recommend that the Commission approve the application. The staff has supported third-party requests for a hearing on an application, and even has asked the Commission to order a hearing when no member of the public has requested one. Two such administrative hearings are now in process at the Commission. When the Commission rejects a hearing request by an interested person, it explains its decision in a memorandum opinion and order.

Public Utility Holding Company Act (cont'd)

Question:

An article in the May 28, 1987 edition of Public Utility Fortnightly observed that "In the wake of repeated unsuccessful attempts to repeal the statute, innovative structural approaches to avoid triggering jurisdiction under the Act have recently emerged and have gained increasing SEC acceptance." We are told that in some instances the utility and staff meet privately, and agree on a corporate structure that does not, in staff's view, implicate a specific provision of PUHCA. The staff then sends the utility a so-called "no-action" letter, stating the staffs' expectation that it will take no action to oppose the proposal. There have been complaints that the public has no opportunity to comment on whether PUHCA is implicated, and does not learn about the transaction until afterwards. Does this occur, and will it continue?

Response:

Since 1936, the Commission has had an informal advisory process for interested persons concerning all statutes administered by the Commission. By the early 1960's, the Commission had developed the present no-action process, which permits people to obtain the informal views of the Commission's staff concerning these statutes. No-action letters typically state that the staff would not recommend that the Commission bring an enforcement action if a transaction is consummated in a certain manner. Requests for no-action advice and responses are publicly available. The Commission is not bound by the staff no-action letters, although it rarely acts in a particular case contrary to them. In addition, a no-action letter does not insulate its recipient from a private litigant who wishes to assert in the courts that the same transaction constitutes a violation of the law.

The Commission believes that the no-action letter process serves a useful purpose. Informal staff advice and assistance to the public promote voluntary compliance and lessen the demand on the Commission's enforcement resources. Louis Loss, professor of law at Harvard Law School, has stated in his treatise on the securities laws that: 1/

> [A]ny person who has an actual problem may obtain an opinion from the appropriate Commission officials in Washington and the field, either by writing or by interview or telephone call. This practice--which a task force of the second Hoover Commission reported as having been "most effectively used" by the SEC--is an

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1/ III L. Loss, Securities Regulation 1894-95 (2d ed. 1961) (footnotes omitted).

essential and popular service with the bar and the securities industry. Thousands of such opinions are given each year.

Public Utility Holding Company Act (cont'd)

Question:

The SEC recently proposed a diversification safe-harbor rule (rule 17) which would allow an exempt intrastate holding company to put up to 10 percent of its consolidated assets into diversified businesses without jeopardizing its exempt status. What rationale did the SEC use in setting 10 percent as a safe-harbor? It has been suggested that proposed rule 17 places consumers more at risk than current regulation which requires case-by-case review of all diversification by exempt holding companies. How do you respond?

Response:

Proposed Rule 17 would establish criteria by which states may create a safe harbor for intrastate public-utility holding companies that wish to diversify; however, in the absence of state exercise of regulatory control over diversification by such companies, the proposed rule would provide a "regulatory" safe harbor for companies seeking to diversify. Under the regulatory safe harbor, interests in non-utility businesses would not be deemed detrimental to the public interest or the interest of investors or consumers ("protected interests") under the "unless and except" clause of Section 3(a) of the Act, and consequently would not cause an intrastate holding company to lose or be denied exempt company status if, basically, four conditions are satisfied.

One of these conditions would be that holding company interests in non-utility businesses not having a functional relationship to its affiliated public-utility companies, when combined with guarantees by the holding company of any obligation of such non-utility businesses, not constitute more than 10% of the consolidated assets of the holding company. In addition, that condition would provide that holding company interests in, and guarantees of obligations of, any one non-utility business may constitute no more than 2% of the consolidated assets of the holding company.

The percentage limitations in the rule as proposed would reflect the degree of diversification of Pacific Lighting Corporation (now Pacific Enterprises) in the early 1970's, when the question of whether to continue the exempt status of that intrastate holding company due to diversification into non-utility businesses was extensively considered by the Commission. Because the vote of the four Commissioners then sitting was split, Pacific Lighting retained its exemption. See Pacific Lighting Corp., 45 S.E.C. 152 (1973). The size limitation currently suggested in the rule derives from the view of the two Commissioners who voted to continue Pacific Lighting's exemption, that the degree of Pacific Lighting's diversification was consistent with its exempt status.

In the release proposing Rule 17, the Commission specifically requested comment on whether the conditions of the safe harbors in Rule 17 are appropriate, whether more restrictive conditions are needed, or whether less restrictive conditions would be adequate. In particular, the Commission invited comment on whether the consolidated asset test and the related percentage limitations are appropriate, whether some other test would be more appropriate, and, if so, what that test should be, and the reasons that test would be more appropriate.

Should Rule 17 and the related amendment of Rule 2 under the Act be adopted as proposed, a diversified exempt holding company that does not come within the regulatory safe harbor three years after adoption (assuming its state provided no safe harbor), and which claimed exemption under Rule 2, would either have to register as a holding company or apply to the Commission for a determination that, despite the unavailability of a safe-harbor, there was no detriment to protected interests on account of unrelated non-utility diversification. During the pendency of such an application, the company would remain exempt if it otherwise met the formal requirements of Section 3(a)(1).

The Commission chose the rulemaking process to give guidance to intrastate holding companies with respect to diversification activities and to avoid calling into immediate doubt the exempt status of any company that has substantial non-utility interests.

Public Utility Holding Company Act (cont'd)

Question:

In FY 1989 you requested that Congress provide funding for 20 staffers in the Office of Public Utility Regulation which is charged to administer the PUHCA. How many staff were you able to hire as a result of the amount appropriated?

Response:

The Commission's Office of Public Utility Regulation ("OPUR") currently employs 14 people. Due to an agency-wide hiring freeze necessitated by the size of the appropriation, the Office operated for several months with one less staff member than it had in FY 1988. Recently, however, as a result of internal reallocations OPUR was able to hire two new staff members, bringing its current size to 14 persons. The Commission, in its budget submission for FY 1989, had requested funding for 19 staff years for OPUR. Time spent on utility matters by other staff members in the Division of Investment Management, particularly on matters involving administrative hearings, adds the equivalent of at least one additional staff member to OPUR.

Public Utility Holding Company Act (cont'd)

Question:

At the current level of 13 or 14 staffers in OPUR, will the backlog of PUHCA non-routine filings increase at a faster level than 400% you projected?

Response:

The Commission's staff currently believes that the backlog of non-routine filings will not increase at a rate faster than initially projected, i.e., 400% with 14 staffers. Non-routine filings include those related to the creation of new holding companies, plans for diversification, and proposed mergers and acquisitions. This anticipated increase in the backlog is predicated on the industry's current regulatory regime. However, if, as some have proposed, legislation were enacted to make the industry more competitive, the numbers and types of companies regulated by the Commission might increase, thereby increasing the number of Commission filings.

Public Utility Holding Company Act (cont'd)

Question:

For FY 1990, you requested only 16 staff for OPUR. Why did you not again request the 20 staffers that you originally sought in FY 1989? Are 20 staffers required to help cut the backlog?

Response:

The Commission requested 19 staff years for OPUR in its FY 1989 congressional budget submission. Since the Commission's 1989 budget appropriation of $142.5 million was not sufficient to support a meaningful increase in any of the Commission's programs for FY 1989, the FY 1990 budget submission reflected allocation of needed increases throughout the agency rather than in any one unit. As a result, the FY 1990 request for OPUR staff did not reflect the real needs of OPUR. OPUR would require approximately 22 staff years in order to eliminate a projected backlog of 139 filings.

Public Utility Holding Company Act (cont'd)

Question:

Given the changing nature of the gas and electric industries (often the result of action by Congress e.g. NGPA), do you expect the number of complex cases filed by the 12 registered holding companies to increase or decrease?

Response:

The staff expects a continued increase in the number of complex applications filed by registered holding companies. The utility industry is currently undergoing significant changes, including diversification into non-utility businesses, construction of cogeneration facilities, creation of new holding companies, and financial restructurings to deal with earlier nuclear plant investments. These changes have resulted in the submission of an increasing number of complex and novel applications to the Commission.

Public Utility Holding Company Act (cont'd)

Question:

Is the Public Utility Holding Company Act unique compared to other statutes administered by the SEC? Can the registered holding companies sell securities, acquire assets or interests in other businesses without prior SEC authorization?

Response:

The Public Utility Holding Company Act is unique in that it requires substantive Commission review and approval of many routine financing transactions. The other statutes that the Commission administers generally rely on full disclosure, rather than substantive review.

The Public Utility Holding Company Act requires every registered holding company to file an application with the Commission with respect to all financings and certain acquisitions and intrasystem transactions, whether routine or otherwise. The Act also establishes certain standards for these transactions. By contrast, under the Investment Company Act of 1940, the Commission is responsible for reviewing only certain nonroutine transactions. Moreover, the Public Utility Holding Company Act regulates the type of security that may be issued by a registered holding company and permits the Commission to declare effective an application to issue securities only if the issue meets certain criteria. The Securities Act of 1933, on the other hand, requires only that all material information with respect to a proposed financing be disclosed to investors, and does not attempt to regulate the merits of the offering. Indeed, unlike the Public Utility Holding Company Act, the Securities Act and the Securities Exchange Act of 1934 are primarily designed to regulate the securities markets and to ensure full and fair disclosures to investors, rather than to require Commission approval of company business transactions.

Public Utility Holding Company Act (cont'd)

Question:

Can the 12 registered gas and electric holding systems be put at a competitive disadvantage because of delays at the SEC? Are exempt electric and gas utilities and independent companies able to gain a competitive edge over registered companies?

Response:

Delays in the consideration of applications under the Public Utility Holding Company Act can put registered holding companies that actively appear before the Commission at a competitive disadvantage compared to exempt and independent utilities. For example, unlike companies not covered by the Act, registered gas utilities must seek Commission approval for the creation of gas brokering subsidiaries. Moreover, other parties may intervene in their applications, thus delaying the process. Two registered gas holding companies have filed applications seeking Commission approval of the creation of this type of subsidiary. The Commission has approved one of these applications, in which there were no intervenors. Outside parties have intervened in the other application proceeding, and the Commission has not yet acted on it. Contested applications often result in litigation challenging the Commission's action and thus additional delay.

Public Utility Holding Company Act (cont'd)

Question:

Given the delays at the SEC in processing complex PUHCA filings, could competitors use the Act to their advantage by intervening in registered company filings to get into new businesses?

Response:

Interested persons can intervene in Commission filings by submitting comments or requesting a hearing on the application. For instance, interested persons have intervened to challenge an application to create a gas brokerage subsidiary. The Commission's rules under the Act provide that the Commission will order a hearing if it deems that a hearing is appropriate in the public interest or in the interest of investors or consumers. A hearing can consist of a legal argument presented to the Commission either orally or through written submissions or an evidentiary proceeding before an administrative law judge. Although the Act permits interested parties to request a Commission hearing with respect to an application or declaration, the Commission's staff will recommend such a hearing only if the intervenor raises a substantial question of fact or law. Moreover, the Act provides that the Commission may permit a party to intervene in hearings if the party's participation in the proceedings may be in the public interest or for the protection of investors or consumers.

The Commission recently denied an intervenor's request for a hearing in connection with an application by a public utility company to permit a simple corporate restructuring. The restructuring was designed to facilitate diversification by the utility into non-utility businesses. The intervenor had participated in related proceedings at the state level and the state public utility commission ultimately decided the issues adversely to the intervenor. Based on several factors, including the intervenor's failure to raise any issue of fact requiring a hearing, the Commission denied the intervenor's request for a hearing. The intervenor has appealed the Commission's denial of its request to the United States Circuit Court of Appeals for the District of Columbia.

Section 16 Questions

Question:

The SEC recently proposed changes in the rules relating to ownership reports filed by officers, directors and principal shareholders. Is it true that the proposal would reduce the ranks of insiders required to file by over 50%?

Response:

The proposal to which you refer is part of a comprehensive review of all rules under Section 16 of the Exchange Act. This is the first such review of these rules and related forms since 1934.

The particular proposal you highlight would provide a regulatory definition of the term "officer" for Section 16 purposes, and is only one of many changes to make the rules more reflective of current market conditions and corporate practice. The proposal looks to the definition of executive officer that is now used under the proxy rules (i.e., any president, vice president in charge of a principal business unit or function, or any other person who performs a policy making function for the company). It is an attempt to define officer in a way that is most consistent with the statutory purpose of Section 16.

Currently there is uncertainty in determining who is an officer for purposes of Section 16. Title alone is not determinative. Consistent with the statutory purpose, judicial decisions have focused on "employee[s] performing important executive duties of such character that [they] would be likely, in discharging these duties, to obtain confidential information about the company's affairs that would aid [them] if [they] engaged in personal market transactions." C.R.A. Realty Corp v. Crotty, [1988-1989 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,140 (S.D.N.Y. Dec. 22, 1988) (quoting Colby v. Kline, 178 F.2d 872, 873 (2d Cir. 1949)). Many companies currently look to the executive officer definition in determining officer status for Section 16 purposes.

The designation as an officer for Section 16 purposes has effects beyond reporting obligations. An officer also is subject to a short sale prohibition and to short-swing profit recovery for purchases and sales within a six month period, even if the officer was not in possession of inside information. Thus, it is important that the definition of officer be clear and limited to one that will achieve the statutory purpose. By applying the executive officer definition used under the proxy rules, the proposal would target those corporate officials likely to have routine access to inside information. The proposed system, including codification of the definition of officer,

would add greater certainty as to who must file and provide a prioritized system for reporting transactions.

It is difficult to determine accurately the numerical impact of the proposed definition on filings because of the present uncertainty as to who is an officer for purposes of Section 16. While some companies may experience a reduction in the number of officers required to file, many companies will be unaffected if the proposed definition is adopted.

Community Impact Disclosure (Senator Pressler)

Question:

My home state of South Dakota and other Midwestern states are facing the possible takeover of two transportation concerns. California investor, Marvin Davis, has made an offer to acquire NWA Inc., parent of Northwest Airlines. An Investor Group known as Japonica Partners is engaged in a fight for CNW Corporation, parent of Chicago and North Western Transportation Company. In view of the very evident public interest in such takeovers, should not the SEC have special rules pertaining to takeovers of that kind in order to protect the public and the service the transportation company provides? (It is my understanding the Department of Transportation and the Interstate Commerce Commission do not have jurisdiction where the would-be acquiror is not engaged in transportation.)

It appears to me, Chairman Ruder, that the information required to be included under the "Purpose of Transaction" caption of Schedule 13D is not at all adequate to protect the interests of the public. For example, should not farmers who rely on the Chicago North Western railroad for hauling grain be informed of what will happen to their rail service? Should business people who have no other option for air transportation than Northwestern Airlines have the right to know what may happen to the service?

Response:

The Commission firmly believes that the federal securities laws should not be amended to require disclosure in a control transaction of the acquisition's impact on communities, employees, or other constituents of a target corporation. Adopting a provision in the federal securities laws to require a community impact statement in disclosure documents would depart from the investor protection purpose of these statutes and would often not result in meaningful disclosure to investors. 1/ The federal securities laws should not be used as the vehicle to address other economic and policy concerns, worthy though those concerns may be. Rather, to the extent that takeovers may cause disruptions, they should be addressed directly through appropriate legislation. Indeed, Congress recently enacted plant closing laws to address concerns over possible lay-offs caused by

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1/ See Statement of Charles C. Cox, Acting Chairman of the Securities and Exchange Commission, Before the Senate Committee on Banking, Housing and Urban Affairs, Concerning Corporate Takeover Legislation, S. Hrg. 183, 100th Cong., 1st Sess. at 99 (June 23, 1987).

takeovers. 2/ Policy issues presented by changes in the control of transportation companies similarly could be addressed under the transportation laws. 3/

2/ See Worker Adjustment and Restraining Notification Act, Pub. L. No. 100-379, 103 Stat. 894 (1988).

3/ As a matter of Commission policy, we cannot discuss specifically any of the transactions mentioned in Senator Pressler's questions, except to note that Japonica Partners has dropped its bid for CNW Corporation.

Section 16 Questions (cont'd)

Question:

How do investors benefit from the deferral of insider data, such as the exercise of stock options, for up to a year?

Response:

Deferring the reporting of certain insider transactions, such as the exercise of stock options, to an annual report would highlight transactions that would continue to be required to be reported monthly on Form 4, and which provide a greater opportunity for abuse of inside information. The current reporting scheme requires the monthly reporting of all transactions and intermingles exempt transactions with non-exempt transactions.

Through the years, the Commission's staff has identified numerous transactions that do not provide insiders with an opportunity for abuse of inside information (e.g., small gifts, stock dividends, stock splits) because the insider is not making a true investment decision. As these transactions have been identified, they have been exempted from Section 16(b) short-swing profit recovery. As part of the revised reporting system, the Commission has proposed that these transactions be reported annually on a new Form 5, rather than on Form 4, in order to highlight non-exempt transactions.

The proposals would exempt the exercise of stock options because insiders acquire their economic interest and opportunity to abuse inside information for purposes of Section 16(b) short-swing profit liability at the time they acquire the option, rather than when they exercise it. However, the sale of the stock acquired upon exercise would be subject to the short-swing liability provisions of Section 16. Since option exercises would, under the proposals, be exempt from Section 16(b), they would be treated in the same manner as other exempt transactions and would be reported annually on Form 5. It should be noted that the principal concern of those commenting on deferred reporting of option exercises is that the sale of stock obtained upon the exercise of options is viewed as less indicative of insiders' views of their company's prospects. Thus, these commentators would prefer that exercises be reported before or at the time the option stock is sold so that they can differentiate between sales of option stock and non-option stock. The Commission will consider this and other concerns expressed by commentators in adopting final rules.

Section 16 Questions (cont'd)

Question:

How do you respond to the criticisms that the proposal decreases the volume of information available to investors and slows down the flow of information to investors?

Response:

The purpose of the comprehensive review was to modernize the rules under Section 16. Under the proposed scheme, some reporting requirements would be increased while others would be decreased. The proposals, taken as a whole, would provide more meaningful disclosure to investors concerning insider transactions.

As discussed in the last question, the flow of information would be prioritized to highlight discretionary insider transactions where there is the greatest opportunity for abuse. Other transactions would be reported annually.

In addition, the proposals would enhance further the information available to investors. First, a new annual report would be required of all insiders to disclose those transactions exempt from Section 16(b) and report year-end holdings. Second, companies would be required to disclose their internal procedures for assisting insiders in complying with the reporting provisions of Section 16(a). Third, companies would identify annually in their proxy statement or Form 10-K annual report the name of any insider who had failed to comply with the reporting provisions. Fourth, many transactions related to benefit plans and dividend reinvestment plans, not required to be disclosed under the current rules, would be disclosed on an annual basis. Fifth, grants of options and other derivative securities would be reported at acquisition rather than when they become exercisable months or even years later.

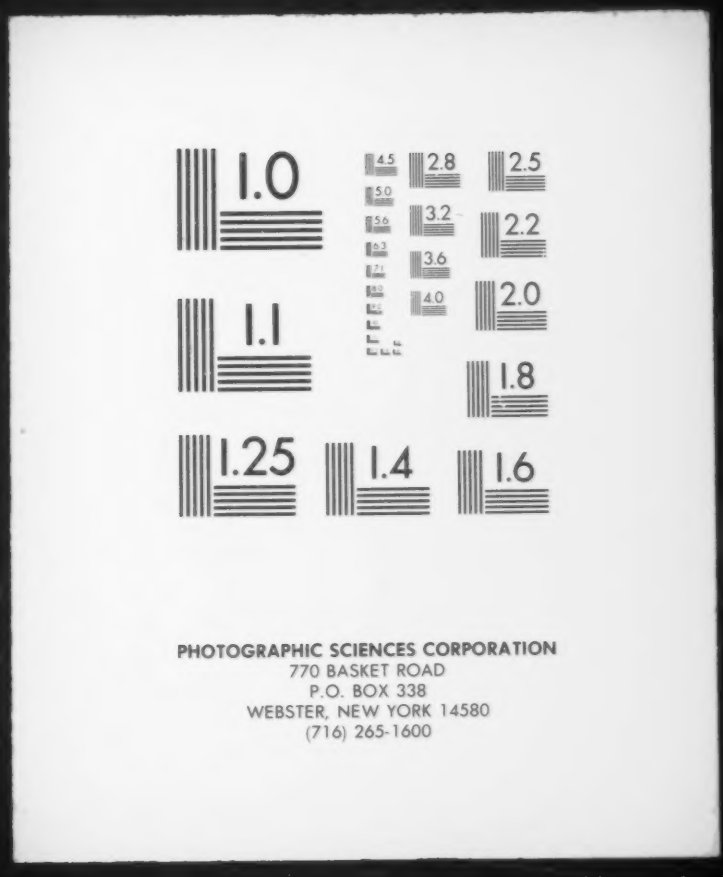
Section 16 Questions (cont'd)

Question:

It has been said that the ownership reports are one of the only sources of factual information available with respect to many so-called "penny stocks." Is this true?

Response:

No. Issuers, including penny stock issuers, whose securities are sold to the public are required by Section 15(d) of the Exchange Act to file annual reports on Form 10-K, quarterly reports on Form 10-Q, and current reports on Form 8-K for the first fiscal year following the sale of securities to the public, and thereafter as long as they have 300 or more shareholders of record. These reports include substantial business, financial, and stock ownership information. In addition, issuers, including penny stock issuers, having 500 or more shareholders and $5 million in assets, or whose securities are registered on an exchange, are subject to Section 12 of the Exchange Act and must file all of the reports mentioned above. Further, they become subject to the Commission's proxy rules and the ownership reporting rules under Section 13(d) of the Exchange Act, as well as the insider ownership reporting rules of Section 16. Thus, there are many publicly available sources of factual information concerning the company, of which the reports under Section 16 are but one.



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